DenizBank Economic Update

January 2019

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

DenizBank

DenizBank Economic Research and Strategy

SBERBANK

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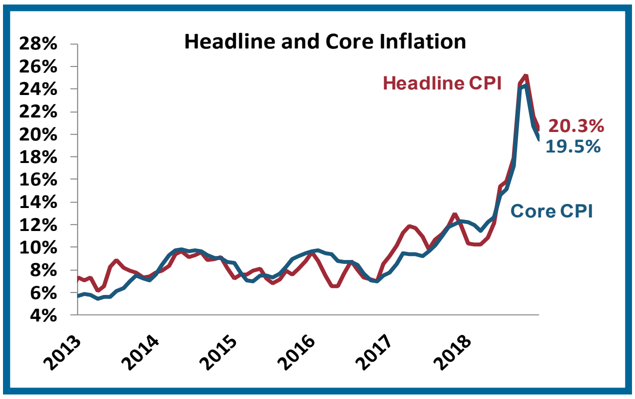
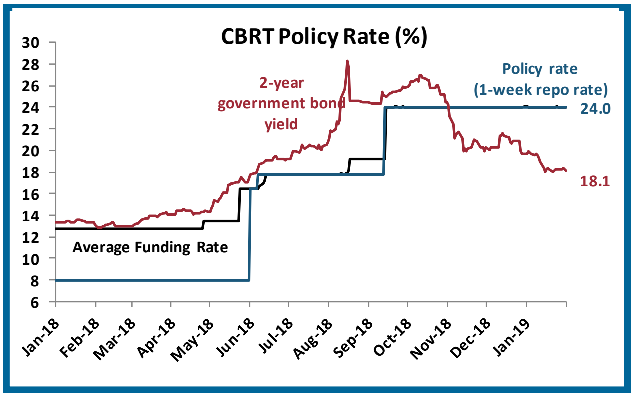
January 2019

DenizBank Economic Update

Economy (I)

Inflation



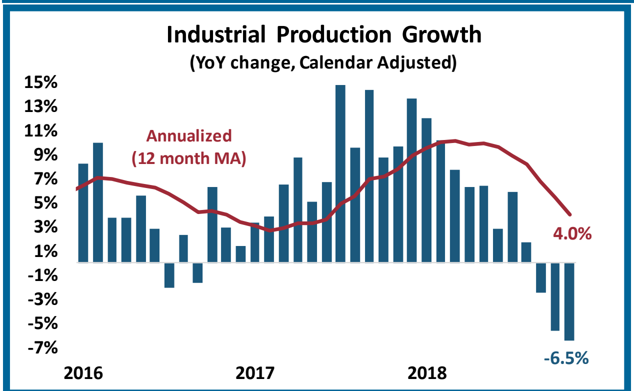


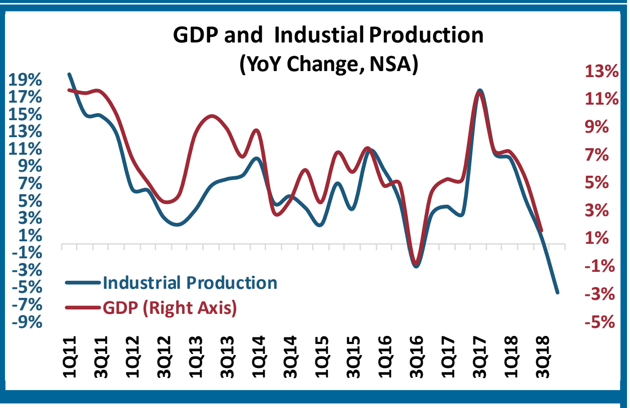
Annual inflation retreated to 20.3% by the end of 2018...

● Consumer prices decreased for the second month in a row by 0.40% MoM in December, pulling annual inflation down to 20.3% from 21.6%. While stability in TL and contraction in domestic demand softened momentum of underlying inflation, transitory factors such as tax cuts in automotive and household equipment, government's anti-inflationary campaign and lower oil prices were the main drivers of disinflation in the last two months of 2018, leading to a 5 percentage points retreat in annual inflation from a peak of 25.2%. However, with producers' price inflation elevated at 33.6% annually and backward-indexation behavior in wages, cost-push pressures persist. We expect inflation to accelerate in the first four months of 2019 up to 22%, before starting a rapid downward trend in 3Q18 towards 12% with the support of favorable base effect. Our 2019 year-end inflation expectation is at 16% (Central Bank expectation: %14.6).

● Central Bank (CB) kept the policy rate unchanged at 24% in January meeting, in line with the market expectations. More importantly, in both the meeting announcement note and January Inflation Report, CB reassured the markets against the prospect of a premature rate cut by keeping the hawkish policy guidance unchanged and preserving the tightening bias. CB reiterated that the tight monetary stance will be maintained until inflation outlook displays significant improvement and further tightening will be delivered if needed. Given the CB's undeterred policy guidance and elevated inflation expectations remaining above 20% in most of the 1H18, we expect CB to keep the policy rate unchanged at 24% until the June meeting.

Growth





Slowdown in economic activity deepened in last quarter of 2018...

● In 3Q18, annual growth decelerated to 1.6% YoY compared to 6.2% YoY in 1H18, its lowest level in the past eight quarters. Yet, leading data signals that economic slowdown became more evident in the 4Q18. Industrial production (IP) fell by 5.3% YoY in October-November period, sharpest decline since September 2009. Combined with 9-year-low manufacturing PMI and capacity utilization rate imprints, such decline in industrial production indicate a c.3% YoY contraction in GDP in 4Q18.

● Sharp decline in auto (-52%) and white good (-21%) sales in 4Q18 demonstrates further weakening in domestic demand despite the temporary tax cuts. On the other hand, net exports continued to make large contribution to growth in 4Q18, thanks to robust external demand and real exchange rate depreciation.

● As growth turns to negative in the last quarter of the year, we expect 2018 full-year growth rate to decrease to 2.5%. We expect consumption and investment growth to turn positive in the 3Q19 with the help of lower interest rates and favorable base effect.

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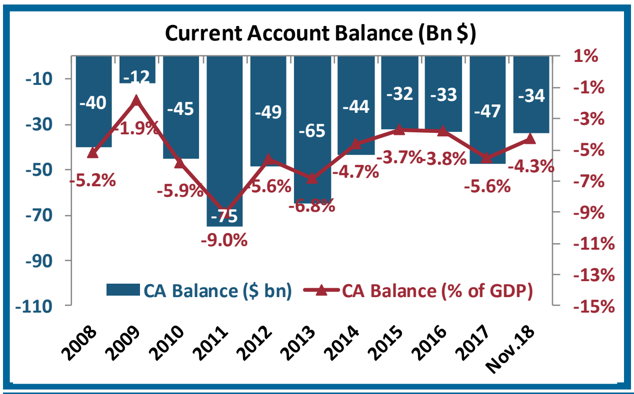
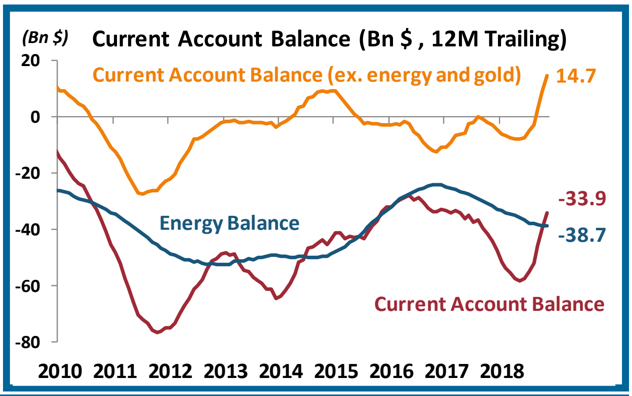
Economy (II)

External Sector





Rapid adjustment in current account balance continued...

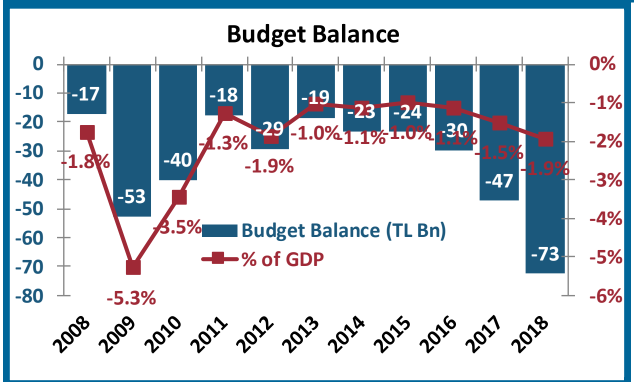
● Sharp slowdown in domestic demand, combined with robust external demand and depreciation in the real exchange rate, led to a rapid improvement in external balances starting from the 3Q18. In August-November period current account recorded monthly surpluses in four consecutive months. In November, 12-month trailing current account deficit (CAD) decreased to $34 bn (4.3% of GDP) from a peak of $58 bn (7.4% of GDP) in May.

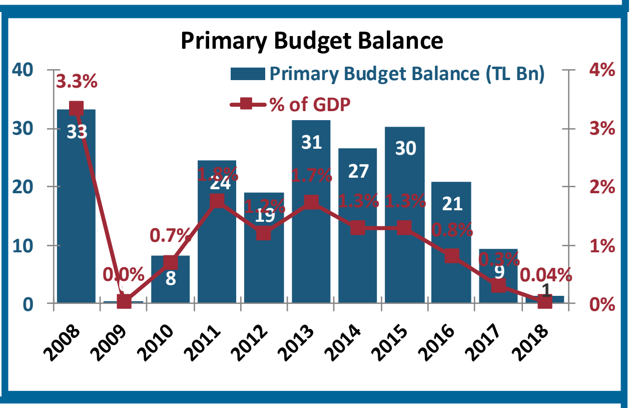
● The $24 bn retreat in CAD compared to its peak in May is driven by a marked improvement in core deficit (exc. energy and gold). As imports decreased by 20% (consumption goods: -39%) in 2H18, core CAD gave an all-time high $15 bn (1.9% of GDP) annual surplus in November. Moreover, prolonged deterioration in energy balance came to an end as oil prices retreated towards 60$ (2018 Avg. Brent oil $72/bbl). Annual energy deficit remained stable at $39 bn.

● On the financing front, despite a limited improvement in FDI and portfolio investments in November ($6.6 bn annually), reserve drawdowns ($19 bn annually) together with net errors and omissions ($19 bn) have been the main source of CAD financing in 2018. Banks' annual external debt rollover ratios decreased to 85% while corporates' remain stable above 143%.

● As rapid decrease in trade deficit (imports down by 28%) continued in December, we expect CAD to decrease to USD 28bn (%3.6 of GDP) in 2018 YE and improve further in the 1H19.

Public Sector





Budget deficit remained under 2% in 2018…

●In 2018 central government budget deficit increased to 1.9% of GDP (TL 72.6 bn) from 1.5% of GDP in 2017, meeting the New Economic Programme target.

● Fiscal stimulus measures such as tax cuts on automotive, housing and durable goods, adjustment in oil prices and lump-sum transfers to pensioners led to a faster increase in budget expenditures relative to revenues in 2018. Increase in tax revenues were limited (up 16%, indirect taxes down 2%) both due to tax cuts and slowdown in domestic demand in 2H18, which was compensated by one-off non-tax revenues (up 45%). Budget expenditures on the other hand, were aggravated by higher interest rates.

● Government commits to fiscal consolidation in 2019 according to the budget plan targeting 1.8% (as % of GDP) deficit and a primary surplus of 0.8% with the implementation of fiscal measures totaling TL 76 bn (1.7% of GDP, TL 60 bn from expenditure cuts and TL 16 bn from higher revenues). Significant slowdown in tax income, absence of last year's one-off revenues and ongoing expansionary policies in 1Q19 poses upward risk on 2019 fiscal targets.

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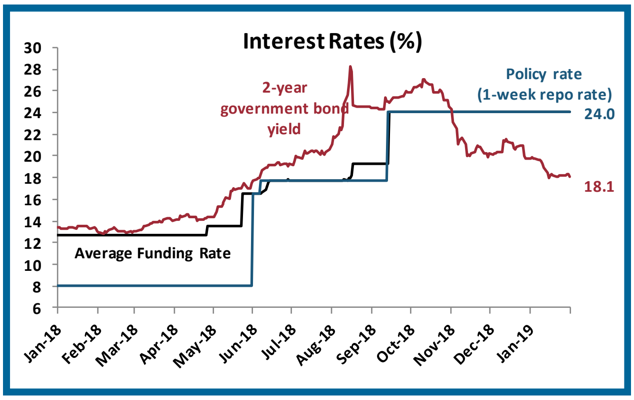
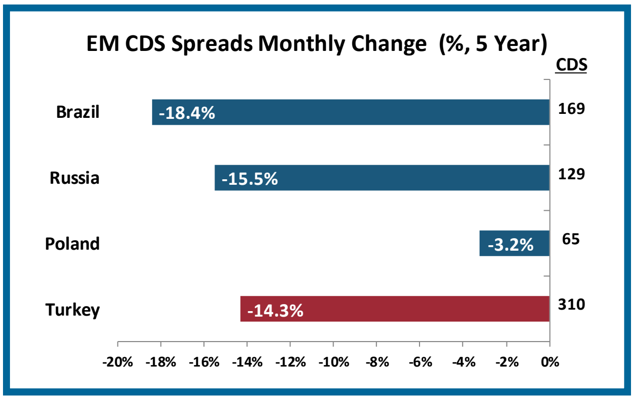
Financial Markets

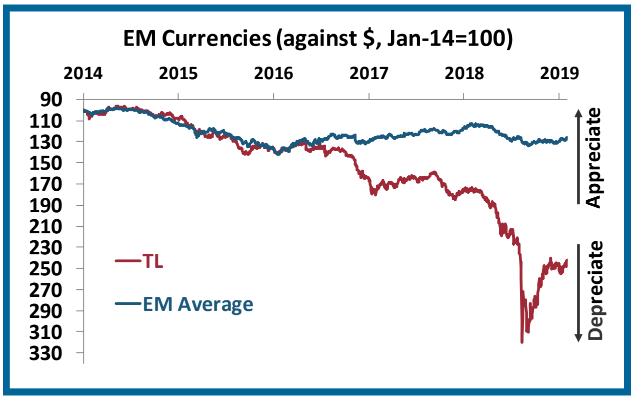
Debt Market

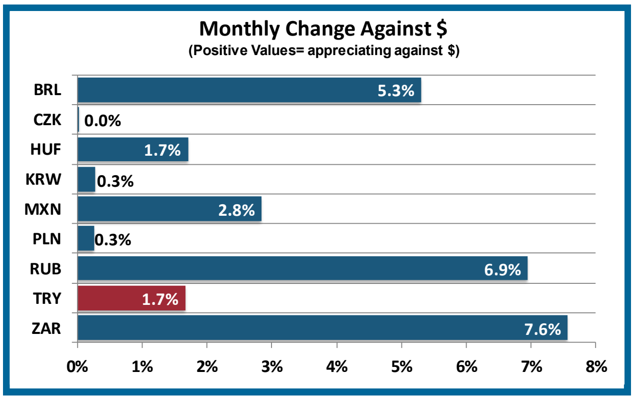




Turkey's funding cost retreated in the beginning of 2019 in line with its EM peers. Turkey's 2-year benchmark bond yield decreased by 150 bps to 18% and CDS declined by 14% to its lowest level in the past six months.

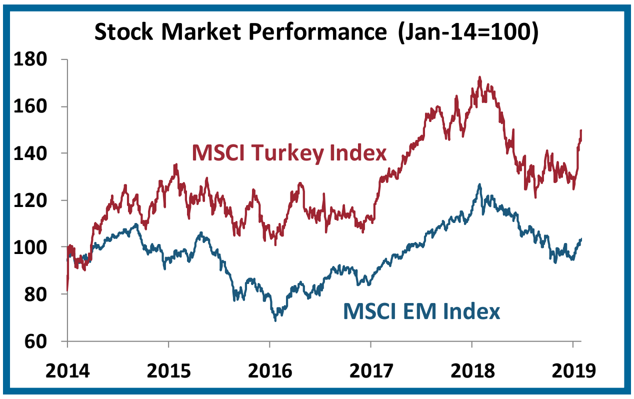
Currency Market

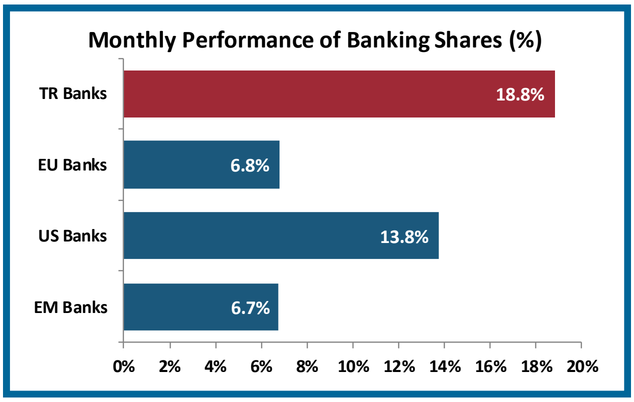




Following a 28% sharp depreciation in 2018, TL appreciated MoM by 2% against USD in January in line with other EM currencies.

Stock Market





MSCI Turkey index was up MoM by 15% (in TL terms) in January, overperforming other EM equity indices (MSCI EM index: +7%).

Data retrieved from Bloomberg as of 13:30 (GMT + 3), 31.01.2019

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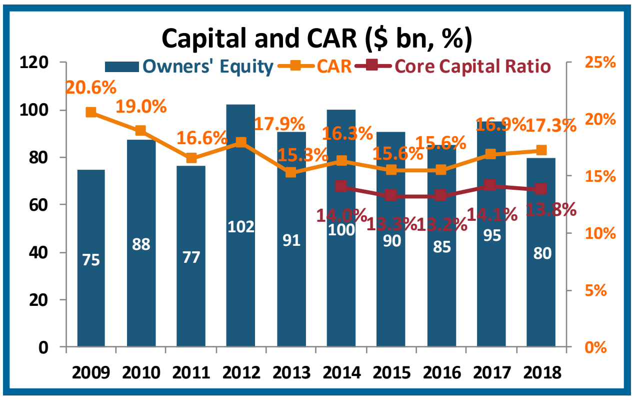
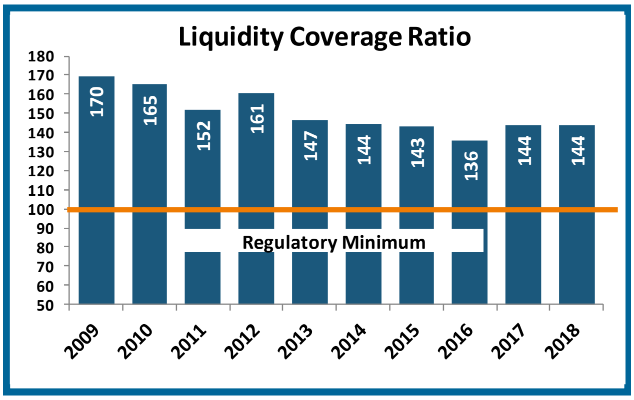
Banking Sector (I)

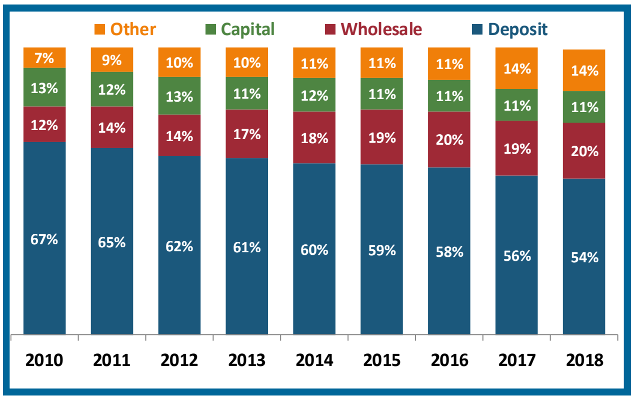
Capital

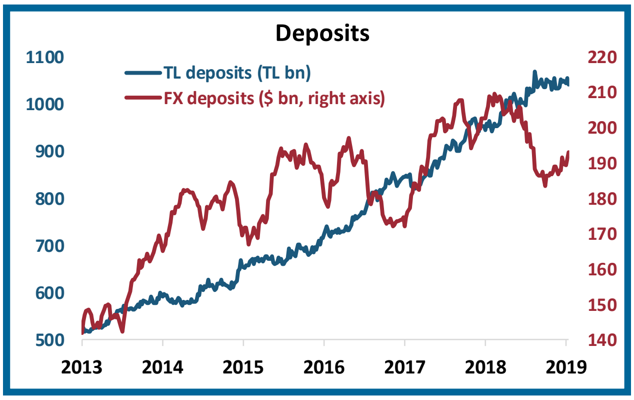




Turkish banking sector has a strong capital base. Capital Adequacy Ratio is at 17.3% as of 2018YE.

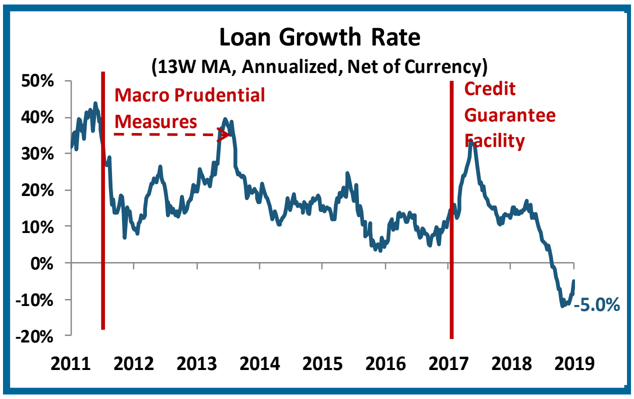
Funding

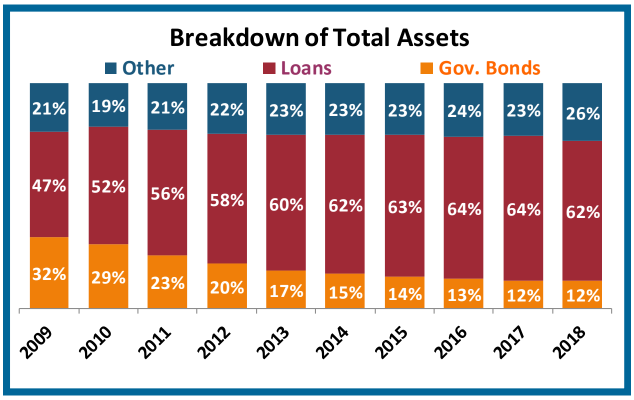




Deposits went up by 20% YoY (2.2% net-of-currency) to TL 2.0 trillion in 2018.

Lending





Contraction in loans (13 week average net-of-currency) moderated to an annualized rate of 5%.

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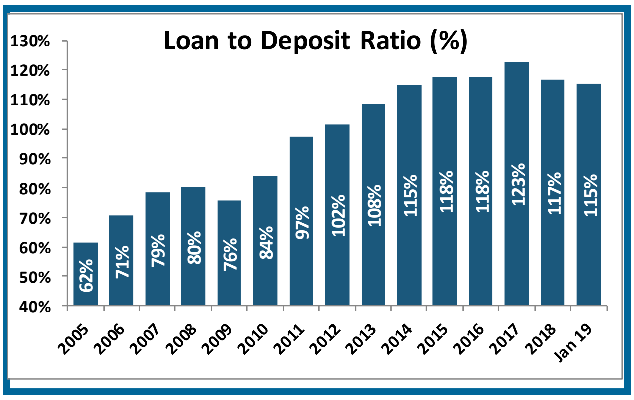
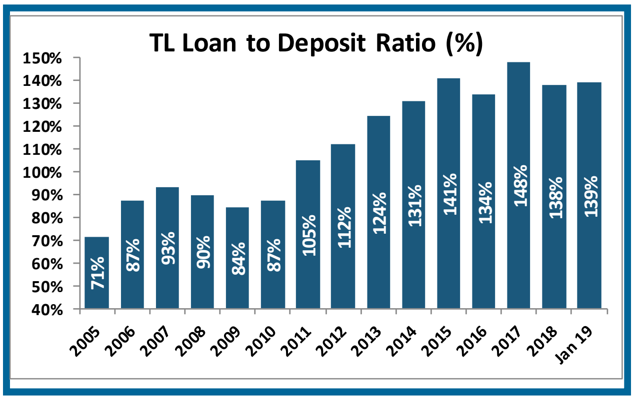
Banking Sector (II)

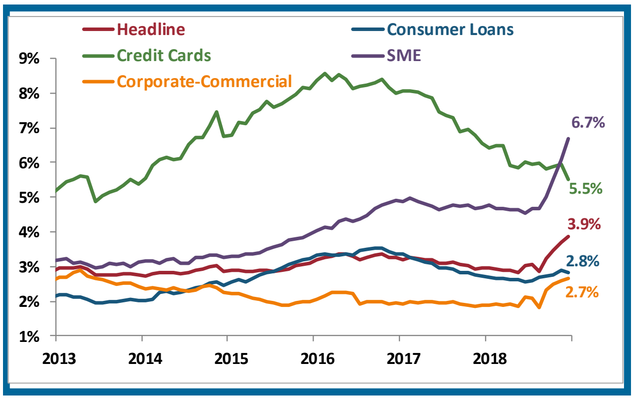
Loan to Deposit Ratios

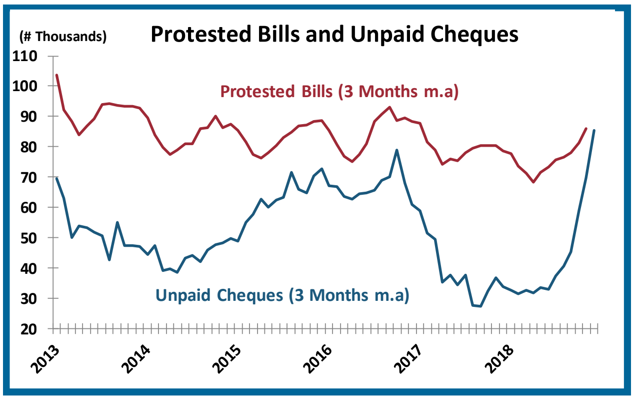




Loan to deposit ratio (LDR) and TL LDR decreased to 115% and 139%, respectively.

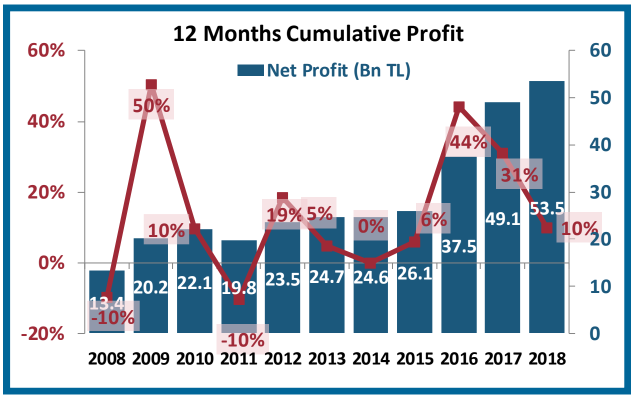
Loan Quality

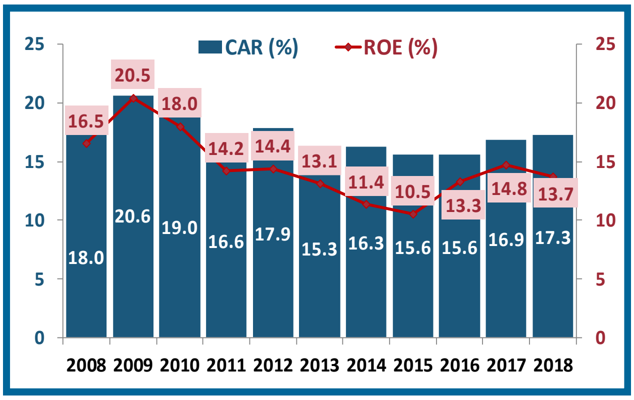




Headline NPL ratio for the banking sector rose moderately to 3.9% in 2018YE from 3% in 2017YE.

P & L





Banking sector's profit increased YoY by 10% to TL 54bn in 2018 . RoE of the sector decreased to 13.7%.