DenizBank Economic Update

July 2018

- Economy
- Financial Markets
- Banking Sector

Economic Research and Strategy

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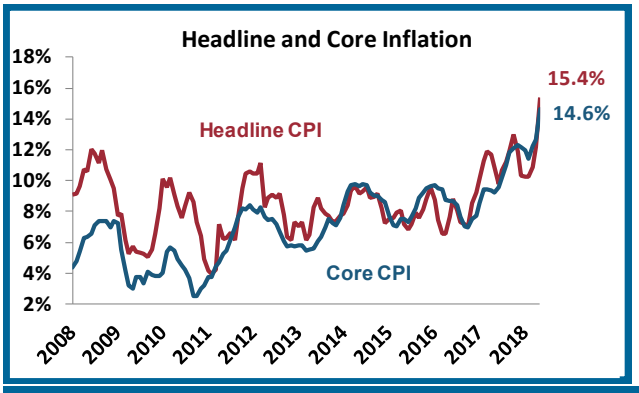
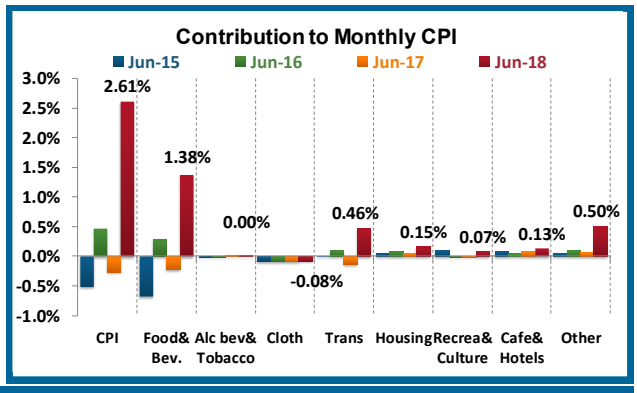
DenizBank Economic Update

Economy (I)

Monetary Policy

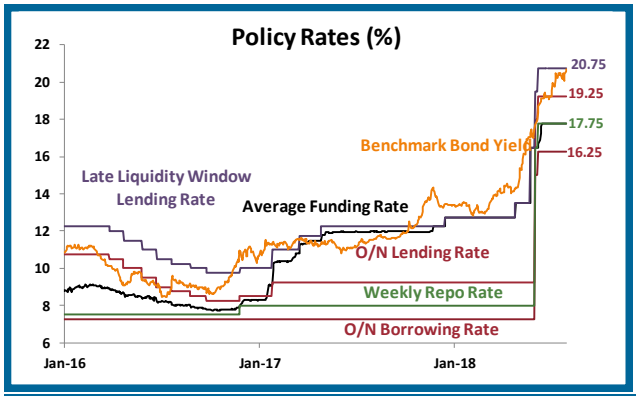


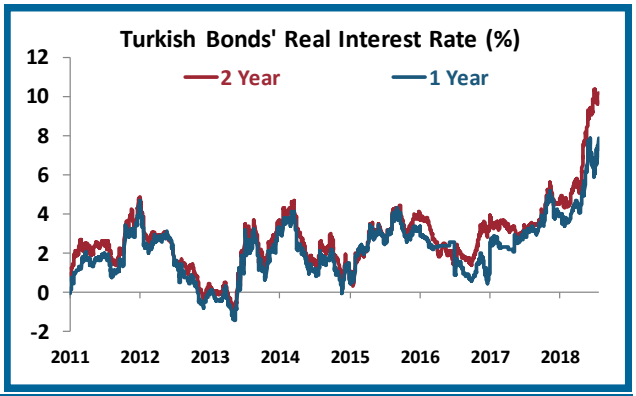


Inflation surprised to the upside in June...

- Monthly headline inflation came at 2.61% in June, doubling the market expectations of 1.30%. Sharp increase in unprocessed food prices (10.8% MoM) along with intensified exchange rate pass-through were the main drivers of the upsurge in consumer prices. FX pass-through was most significant in transportation and durable goods prices.
- June imprint took the annual inflation up to 15.4 % from 12.1% in May, highest level of the 2003-based CPI index. Core inflation (14.6%) gained momentum with broad based FX-push increase in good and services prices. Annual producer price inflation reached all time high to 23.7%, suggesting aggravated cost pressures from TL depreciation and higher energy prices.
- Given the further weakening in TL in July (MoM by 6%), exchange rate pressure is likely to continue throughout 3Q18 taking the annual inflation up to 16-17% range together with the negative base effect. As slowdown in economic activity becomes more visible and exchange rate stabilizes, we expect inflation to decelerate starting in 4Q18. In light of higher-than-expected June imprint, we revise our year-end inflation expectation to up to 14%.

Inflation





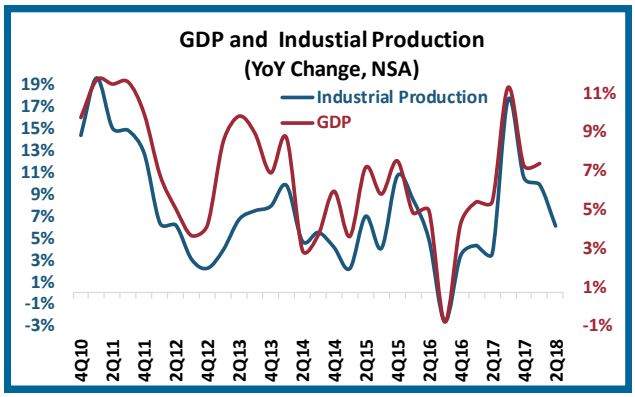
Central Bank remains on hold in July meeting contrary to the consensus view…

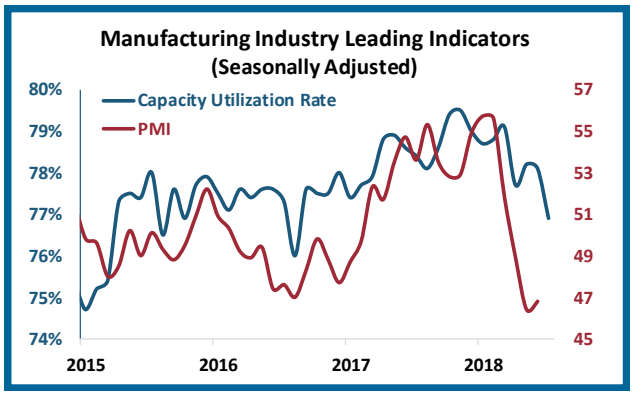
- The Central Bank of Turkey (CBT) held the policy rate (one-week repo) constant at 17.75% in July meeting in contrast to market expectation of a 100 bps hike. The CBT kept O/N lending (19.25%) and O/N borrowing (16.25%) and late liquidity window (20.75%) rates unchanged, as well. CB continues to provide all funding through one-week repo rate and the average funding rate remains at 17.75%.
- According to the statement, the CBT recognized the ongoing deterioration in the inflation outlook which is driven by cost factors and volatility in food prices. However, the CBT also cited the slowdown in economic activity which together with the lagged impact of recent tightening in monetary policy, will start to lead to a period of disinflation in the upcoming period.
- Overall, the tone of the decision statement was hawkish as the CBT acknowledged the upside risks on price behaviour and stressed that the monetary policy will remain tight for an extended period. The statement suggests that the CBT still recognizes the risks but wants to watch the impact of current monetary policy and rebalancing in the economy on inflation before increasing rates further. We can also infer from the statement that CBT remains ready to deliver further tightening if the inflation does not ease as expected.

DenizBank Economic Update

Economy (II)

Growth

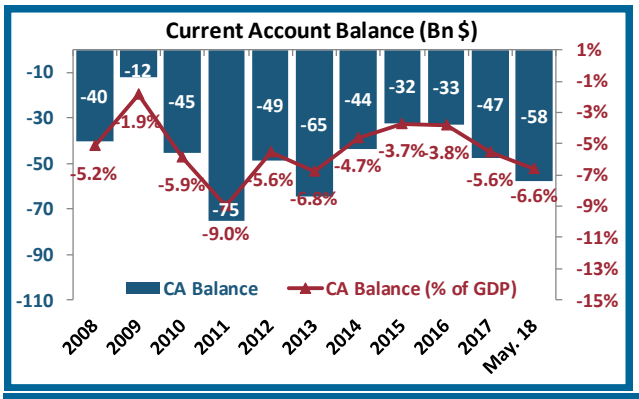


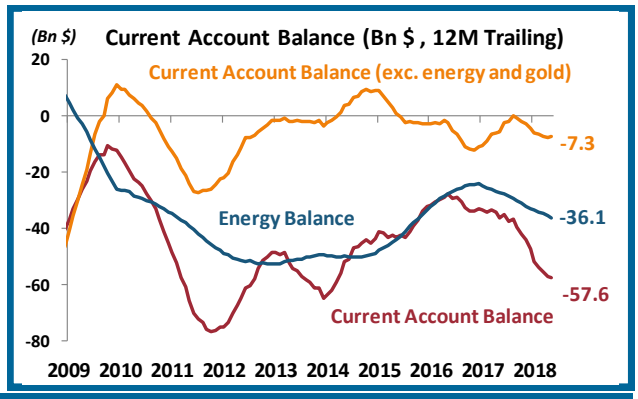


Economic activity moderates starting in the second quarter of 2018…

- Following a solid 7.4% growth in 1Q18 (7.9% annualized), economic activity started to moderate in 2Q18. Industrial production (IP) grew YoY by 6.1% in April-May period compared to 9.9% in 1Q18. Manufacturing PMI, which was at its highest level (55.7) in seven years in the 1Q18, fell sharply below 50 threshold to an average of 47.4 in 2Q18. Industrial production and leading indicators suggest that 2Q18 GDP growth will be in the range of 4.5-5.0% with the support of robust domestic demand.
- Moreover, survey-based indicators suggest a more significant rebalancing in economic activity going into 3Q18. The manufacturing industry capacity utilization rate, which was close to a ten-year peak (78.9%) in 1Q18, declined to 76.9% in July 2018, lowest in the last two years.
- We expect rebalancing in economic activity to be more visible in the remaining of the year with tighter domestic demand conditions resulting from higher interest rates. In addition, we expect fiscal policy to become less accommodative after elections, as promised by the authorities. Overall, we expect 2018 full-year growth rate to be 3.0%-4.0%.

External Sector





Widening in the external deficit slows down in May…

- Current account deficit (CAD) continued to widen in May ($5.9 bn in 2018 vs $5.4 bn in 2017), though at a slower pace. 12 month trailing CAD increased YoY by 59% to $57.6 bn (6.6% of GDP).
- Surge in gold imports and higher energy prices were the main reasons behind the deterioration in CAD. 12 month trailing net gold imports reached $14.3 bn in May from $3.5 bn a year ago. With rising oil prices (from $50 to $75),12 month trailing energy deficit went up YoY by 32% to $36bn. CAD excluding energy and gold imports ($7.3 bn annually) which has been on the rise since the beginning of 2H17 on the other hand decreased for the first time which is an indication of weakening domestic demand conditions.
- On the financing side, loans provided by banks and corporates from abroad together with banks' deposits has been the main source of CAD financing (20.3 bn annually). Portfolio investments (12.3 bn annually) and FDI (6.5 bn annually) continued to decrease in May
- We expect slow-down in economic growth to ease the upward pressure on CAD starting in June and recovery in tourism sector and exports to be supportive. Our year-end CAD to GDP expectation is at 6-6.5%.

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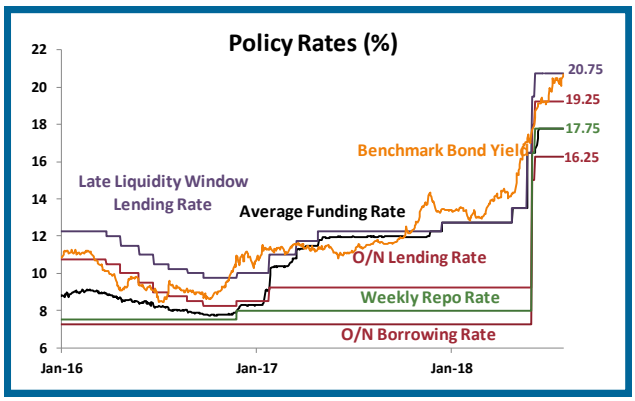
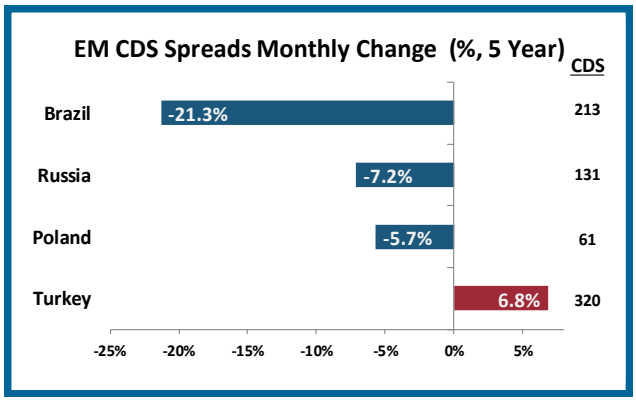
Financial Markets

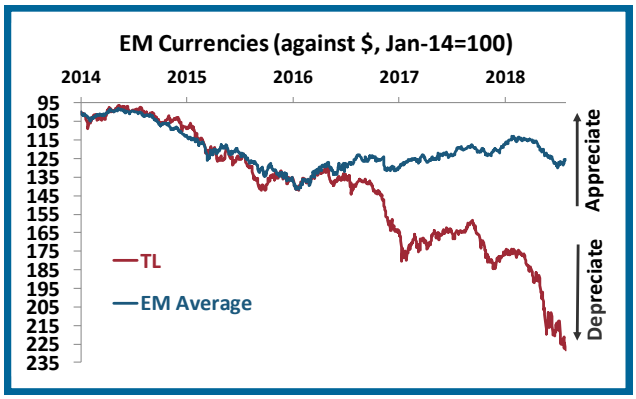
Debt Market

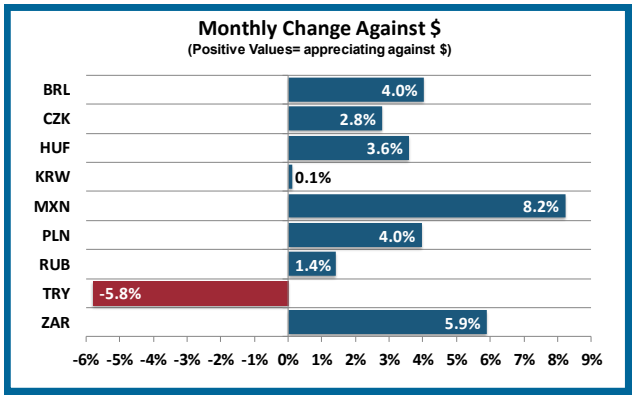




In June, Turkey's 2-year benchmark bond yield increased further by 140 bps to 20.7% (2017: 13.4%)

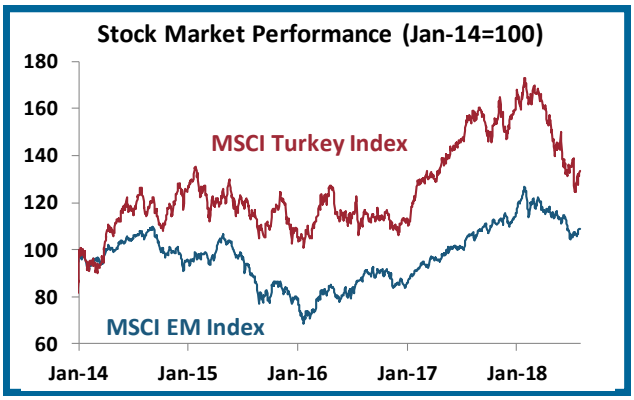
Currency Market

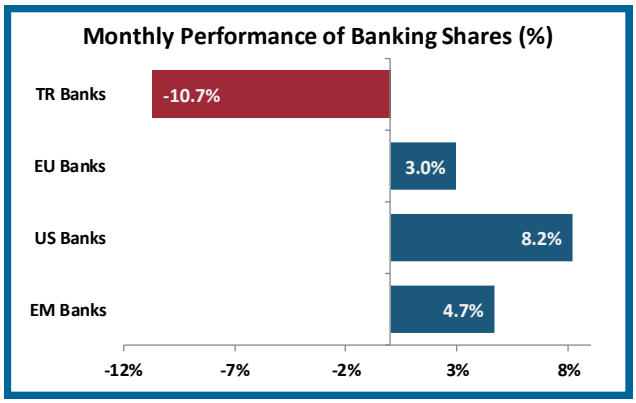




TL depreciated by 6% MoM in July, diverging negatively from EM peers. TL depreciated YtD by 23%, becoming the most volatile currency after Argentine Peso.

Stock Market





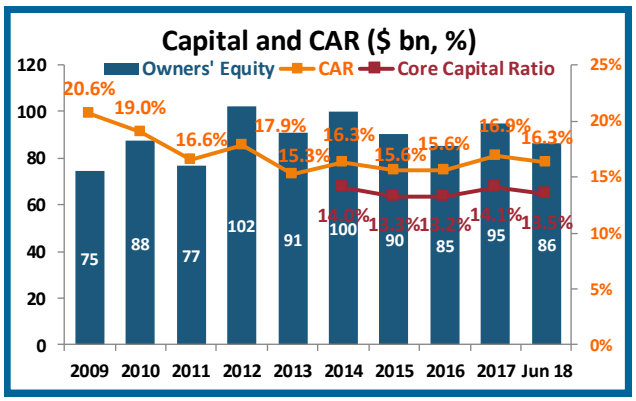
MSCI Turkey index was down MoM by 1.4% and YtD by 19% in July, underperforming EM peers (MSCI EM down YtD by 6%).

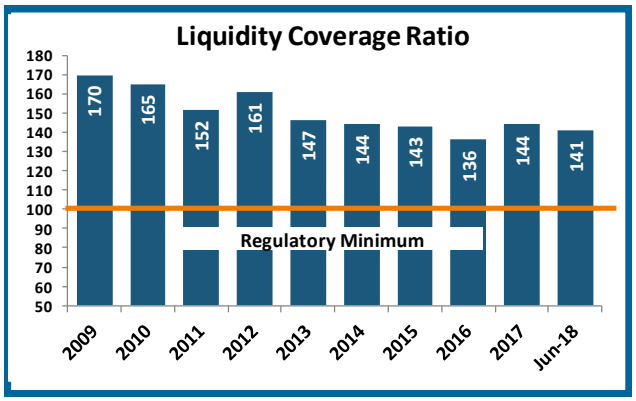
Data retrieved from Bloomberg as of 17:00 (GMT + 3), 31.07.2018

DenizBank Economic Update

Banking Sector (I)

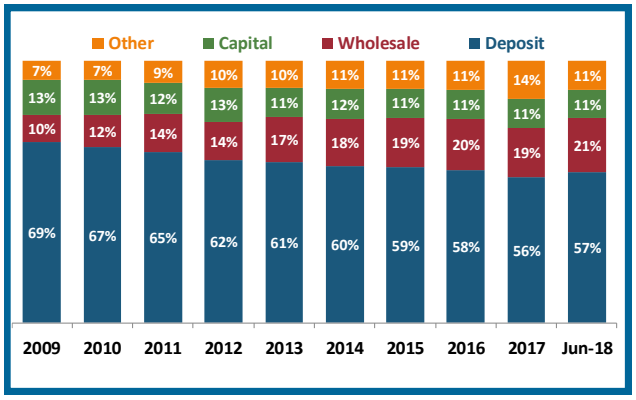
Capital

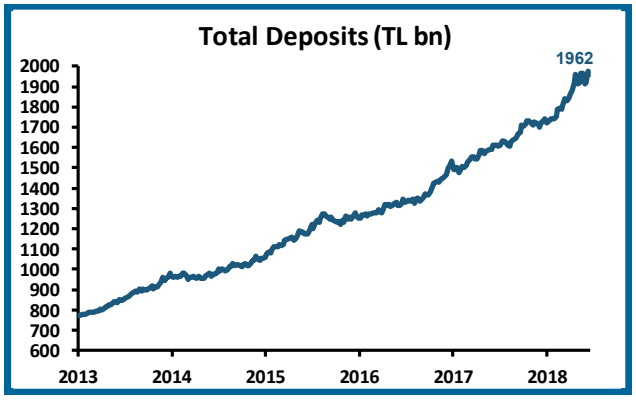




Turkish banking sector has strong capital base. Capital Adequacy Ratio is at 16.4% as of end 1H 2018.

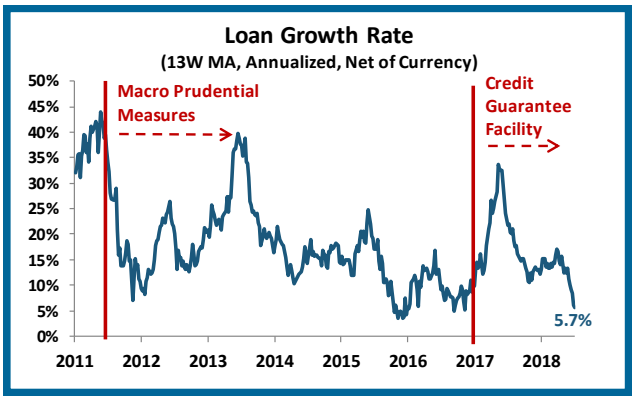
Funding

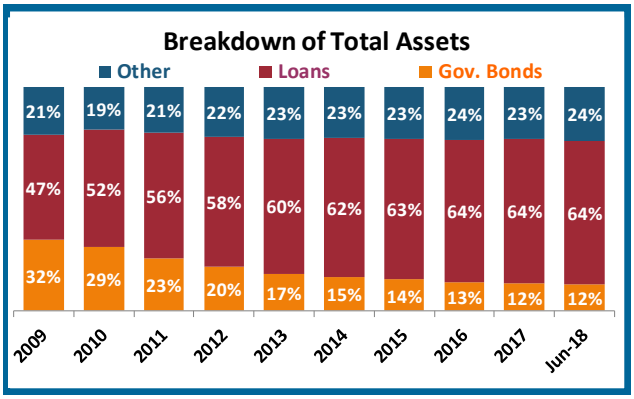




Deposits went up YoY by 22% to TL 2.0 trillion as of July 20th. Share of deposits in funding is stable at 57%.

Lending



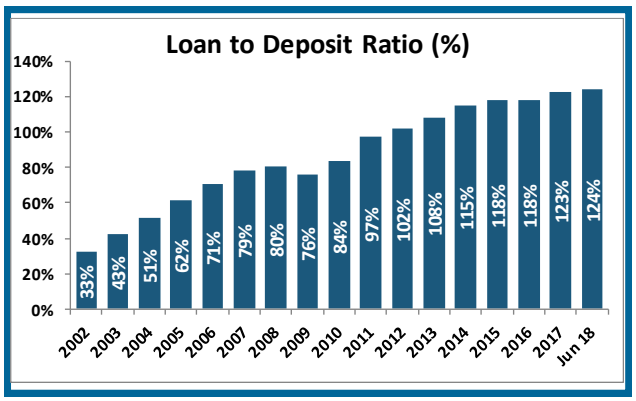


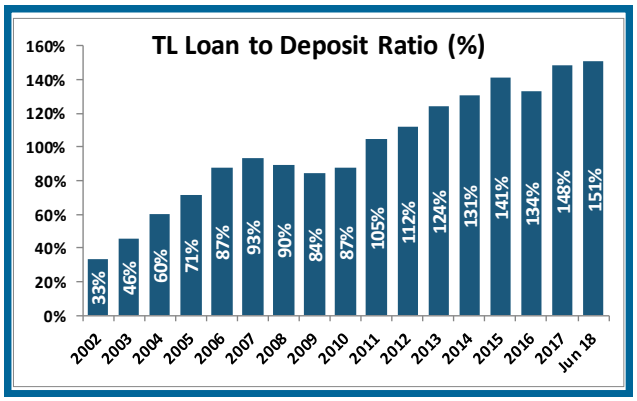
Annualized net-of-currency loan growth decelerated to 5.7% as of July 20th.

DenizBank Economic Update

Banking Sector (II)

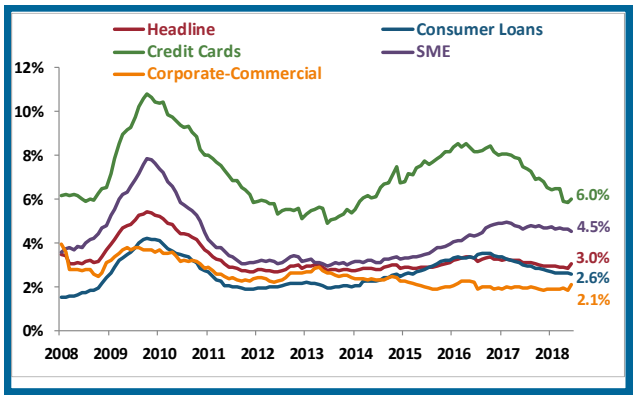
Loan to Deposit Ratios

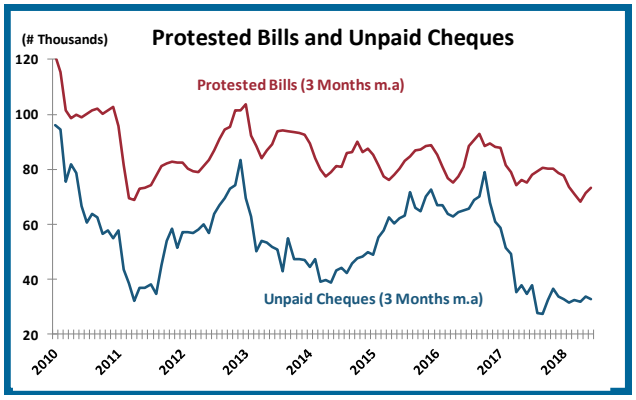




Loan to deposit ratio (LDR) and TL LDR has risen to 124% and 151%, respectively.

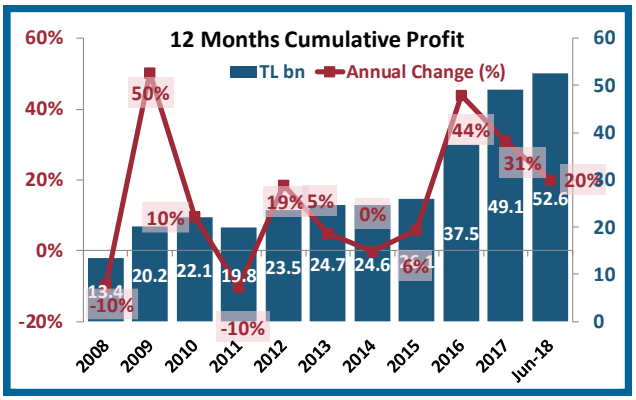
Loan Quality

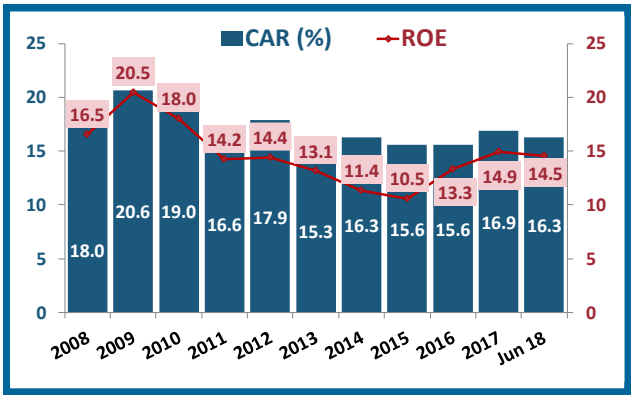




Headline NPL ratio for the banking sector is stable at 3.0%.

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%.