DenizBank Economic Update

June 2019

- Economy
- Financial Markets
- Banking Sector

DenizBank Economic Research and Strategy

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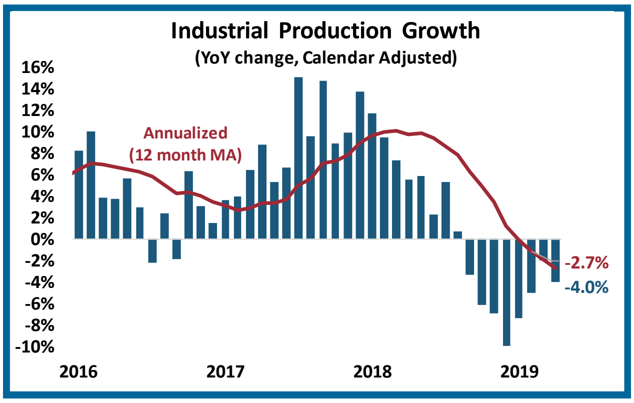
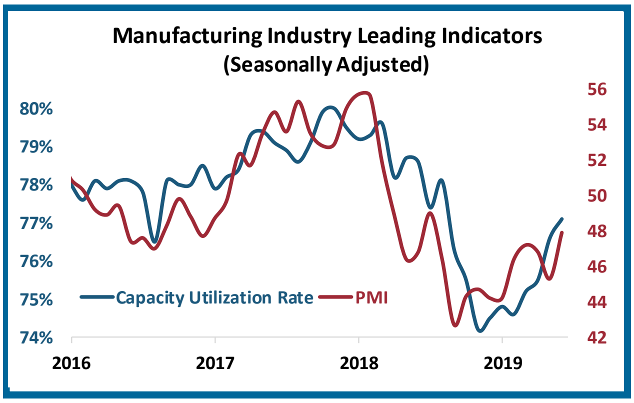
DenizBank Economic Update

Economy (I)

Growth





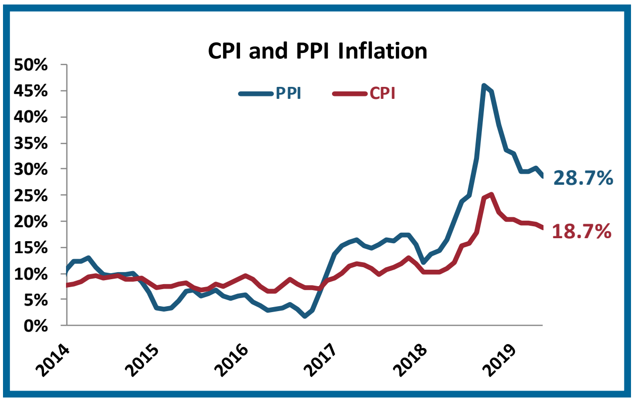
Economic activity has recovered moderately in the first half of 2019

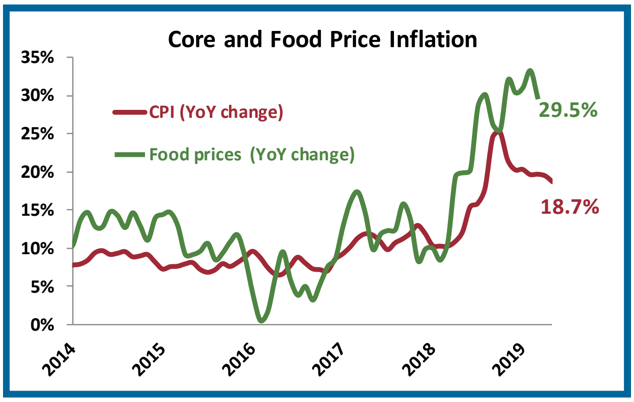
● Turkey's GDP contracted 2.6% YoY in 1Q19, denoting a slight improvement on the 3% YoY contraction in the last quarter of 2018. 1.3% growth compared to 4Q18 on seasonally adjusted basis, following three consecutive quarters of QoQ contraction, meant Turkey is out of recession, according to its technical definition.

● Preliminary data suggest annual contraction in the economy continued in 2Q19, albeit at a slower pace. As volatility in financial markets increased in late March and pick-up credit growth in the first quarter stopped, contraction in industrial production accelerated (-4%) in April. Leading indicators point to sluggish economic activity in May, as well. However, as economic sentiment improved once again in June, PMI manufacturing increased to 47.9 (11-month high) and capacity utilization rate rose 76.6% (10-month high), signaling an increase in industrial production for the first time since August 2018.

● Overall, June imprints suggest bottoming up in the economy continues despite a temporary setback in the beginning of second quarter. Yet, recovery should be gradual, as loan growth is still in the negative territory and further fiscal support is unlikely with the deterioration in budget deficit. We expect annual growth to turn to positive in 2H19 with the help of low base effect, and 2019 full-year growth rate to be 1%, significantly below its potential.

Inflation





Inflationary pressures are subdued by weak domestic demand

● Monthly inflation surprised to downside for the second consecutive month in May, bringing annual inflation down to 18.7%, thanks to both significant retreat in core inflation and normalization in food prices. Core inflation moderated further to 15.9% (from a peak of 24.3% in Oct'18), as supply-side price pressures are partially subdued by weak domestic demand. Meanwhile, despite monthly deflation in May, food inflation remains stubbornly high at 29.5%, well above Central Bank's 2019 forecast of 16%. Moreover, cost-push pressures are still strong, with producers' price inflation high at 28.7% and 7% depreciation in TL in the first half of 2019.

● In the light of April and May inflation imprints, we revise our 2019 inflation expectation downwards, mainly because FX pass-through to inflation has been milder than we previously anticipated, reflecting the weak domestic demand. On the back of strong base effect starting in June, we expect inflation to decrease rapidly to 9% in September-October, before finishing the year at 13%.

June 2019

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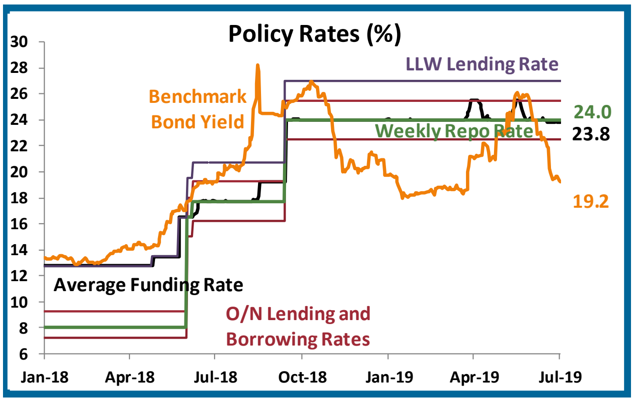
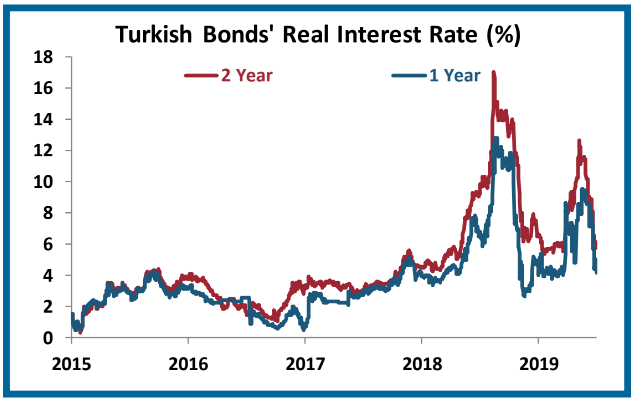
Economy (II)

Monetary Policy



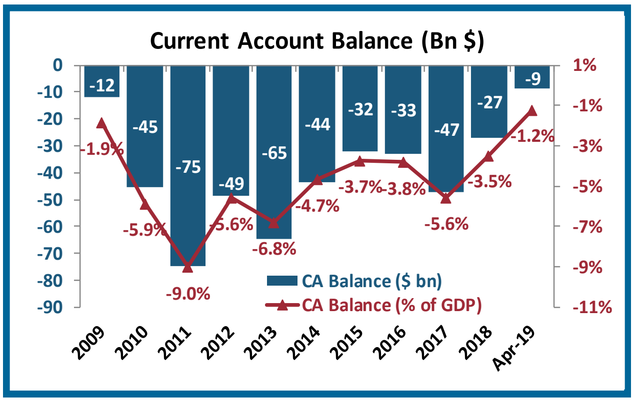


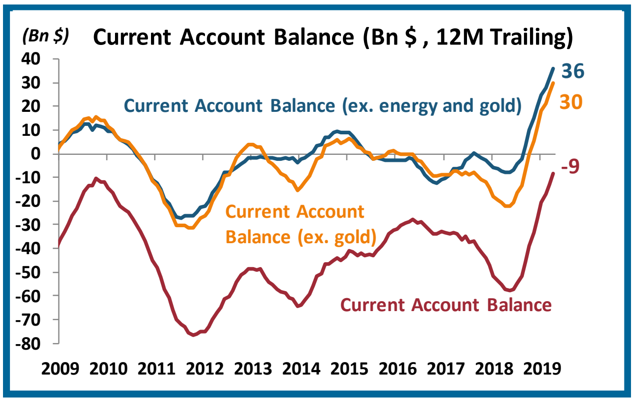
Central Bank may start its easing cycle as soon as this month

● Central Bank (CBRT) kept the policy (one-week repo) rate unchanged at 24% for the ninth month in June meeting as widely expected. Yet, CBRT's statement on monetary policy was less hawkish, with the removal of emphasis on the risks to price stability and commitment to maintaining tight policy, raising the expectations of a rate cut in July. Moreover, perceived as a beginning to the easing cycle, Central Bank opened a new liquidity facility for the primary dealer (PD) banks, providing certain amount of funding to PDs at interest rate already 100 bps below the policy rate, bringing average funding rate to 23.8%.

●Given the faster-than-anticipated disinflation process, recent appreciation in TL (7% since the end of May), easing signals from core central banks and extended weakness in domestic demand, it is likely that the CBRT will start rate cuts earlier than previously forecasted. Based on our revised inflation trajectory, we expect CB to start its easing cycle in July with an initial cut of 100 bps, and deliver a cumulative 400 bps cut till the end of 2019.

External Sector





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

● Contraction in economic activity and imports, combined with steady increase in goods exports and services revenues led to a rapid improvement in Turkey's external balances starting in 2H18. While imports decreased by 20% in the last 12 months following the sharp depreciation of TL, exports increased by 5%. Meanwhile, rising net tourism and transportation income balanced out most of the remaining external trade deficit. As a result, annual current account deficit (CAD) decreased to $9 bn (1.2% of GDP) in April from $57 bn (6.5% of GDP) a year ago, its lowest level since 2004. Current account surplus excluding energy and gold reached record high level of $36 bn (%5 of GDP).

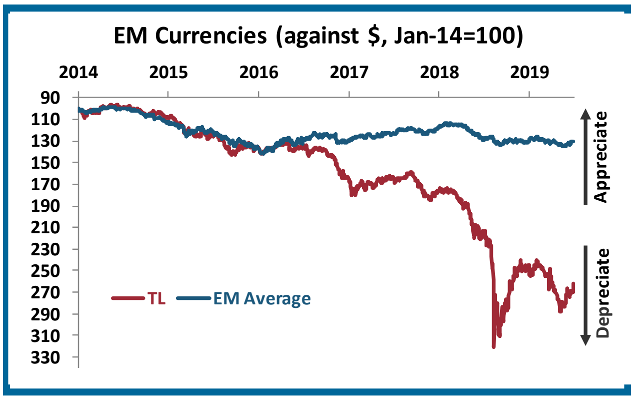
● On the financing side; reserve drawdowns ($15 bn), net errors and omissions ($12 bn) and FDI inflows ($10 bn) compensated for banks' debt repayments ($19 bn) and deposit outflows ($23 bn), and financed the shrunken current account deficit. Financial account recorded $0.5 bn portfolio outflows annually, compared to $ 19 bn inflow same period the previous year.

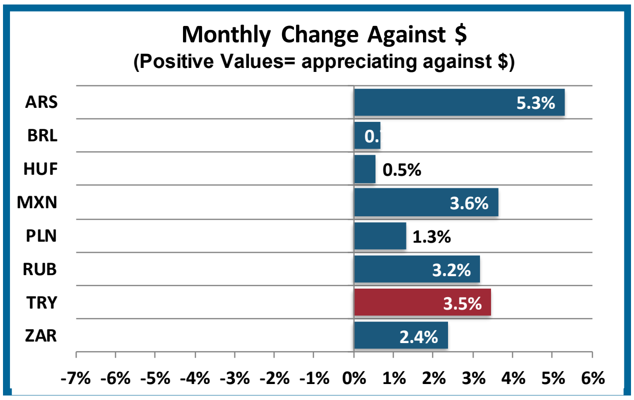
● In May-June period, annual trade deficit decreased further by $8.3 bn, suggesting current account balance have turned to a surplus for the first time since 2002. As economic activity picks up gradually in 2H19, we expect CAD/GDP to finish the year at 1%.

DenizBank Economic Update

Financial Markets

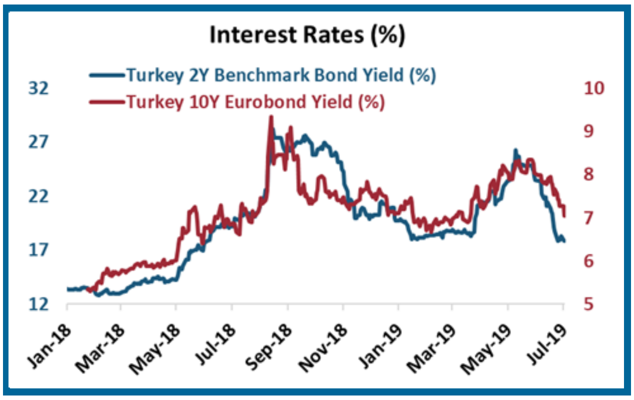
Currency Market

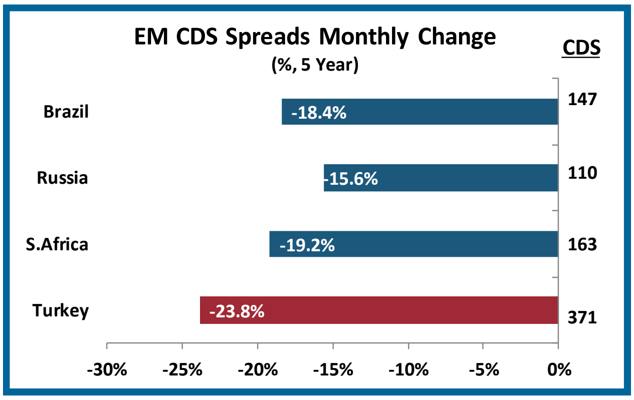




Supported by accommodative stance of core central banks and decreased political risks, Turkish Lira appreciated by 7% since the end of May. Despite recent appreciation, TL remains as the weakest performing EM currency on year-to-date basis (-7%) after Argentine Peso.

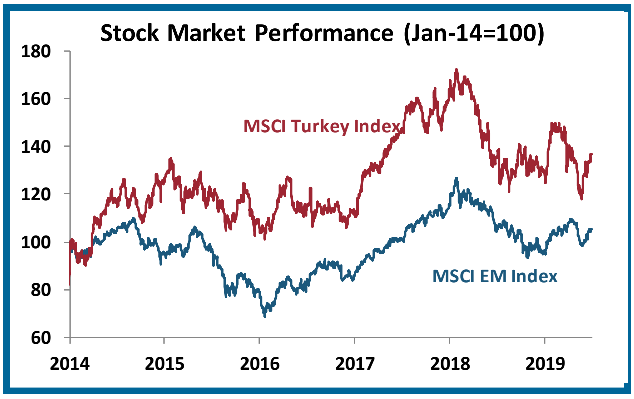
Debt Market

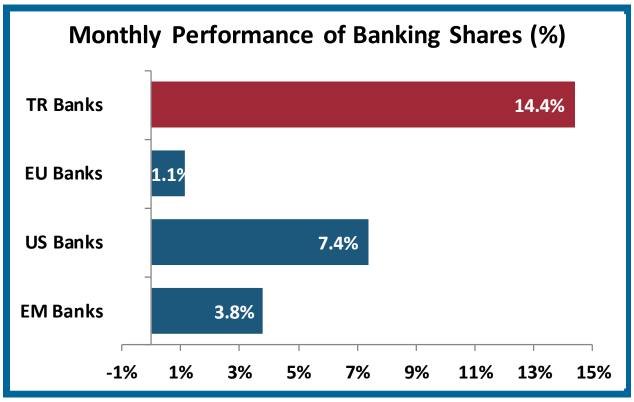




Thanks to the positive sentiment in June, Turkey's risk premium and funding cost decreased significantly compared to the recent peak in May. Turkey's CDS spread fell to 370 bps and 2-year TL benchmark bond yield decreased 570 bps down to 19.2%, lowest since March 2019.

Stock Market





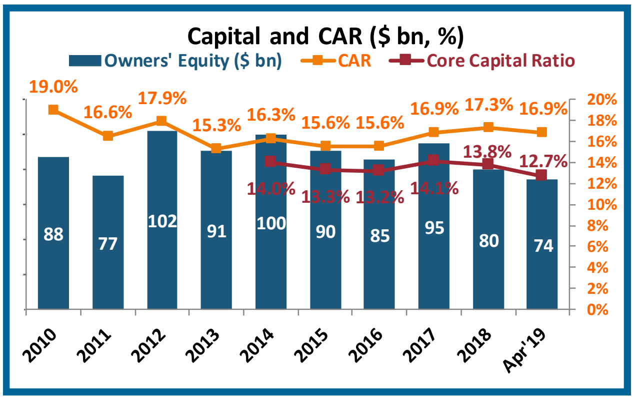
MSCI Turkey index was also up 11% (in TL terms) in June led by banking shares, overperforming EM peers (MSCI EM index was up 7%) and bringing year-to-year gains up to 9.1%.

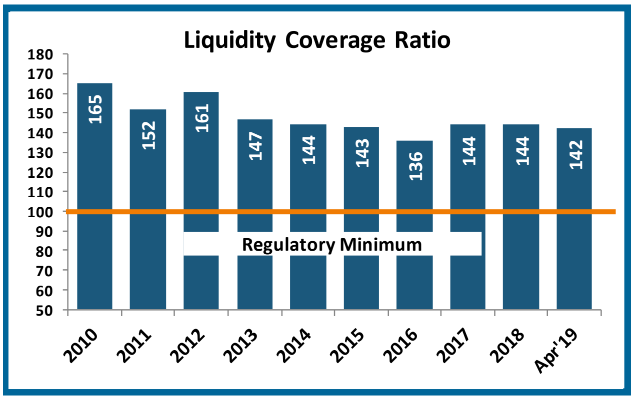
Data retrieved from Bloomberg as of 13:00 (GMT + 3), 02.07.2019

DenizBank Economic Update

Banking Sector (I)

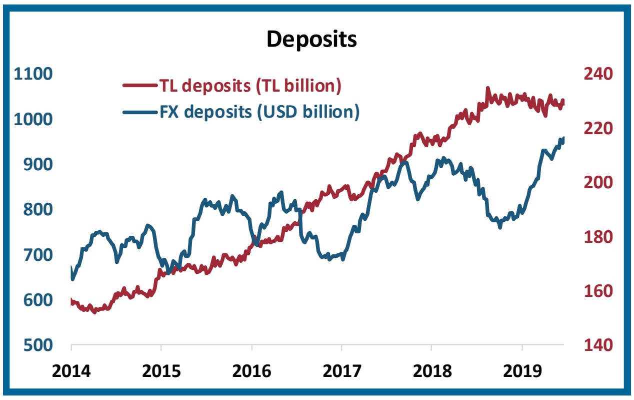
Capital

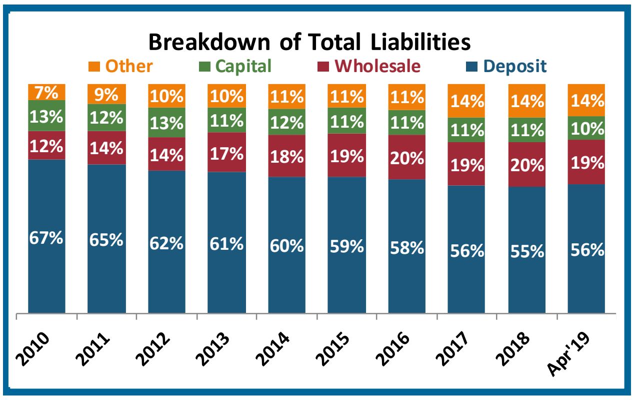




Turkish banking sector has a strong capital base. Capital adequacy ratio is at 16.9% as of Apr'19.

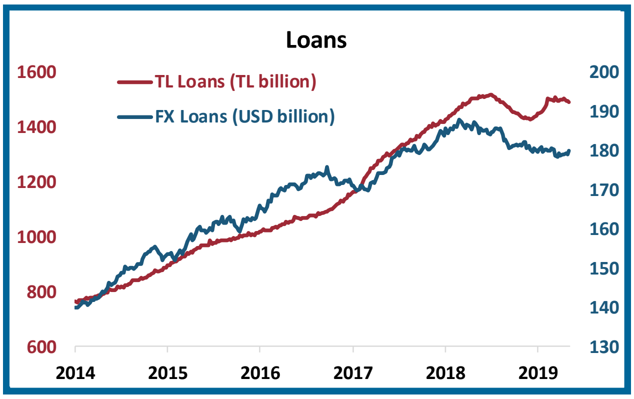
Funding

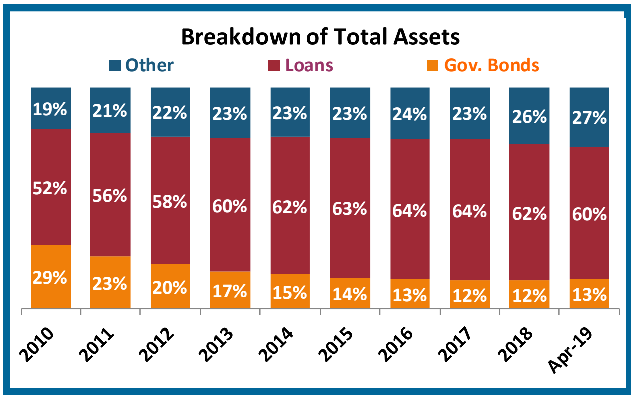




FX deposits went up by 15% since the beginning of 2019 while TL deposits decreased by 1%.

Lending





Year-to-date loan growth has been weak at 7.9% (1.8% net-of-currency) since the beginning of the year.

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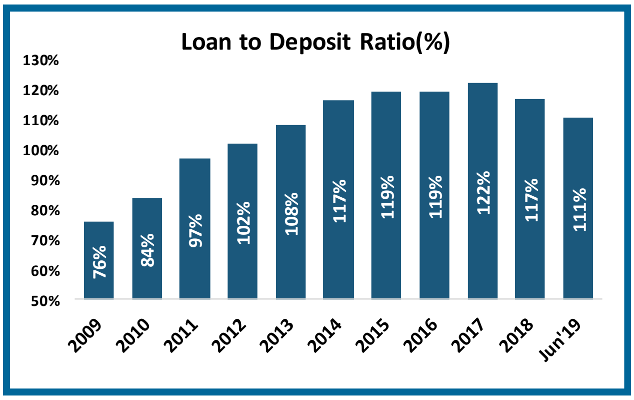
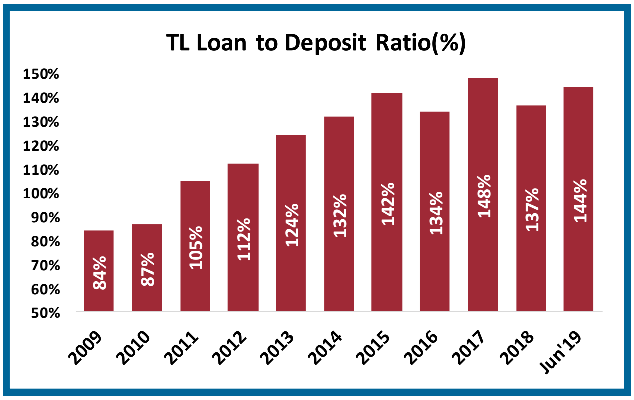
Banking Sector (II)

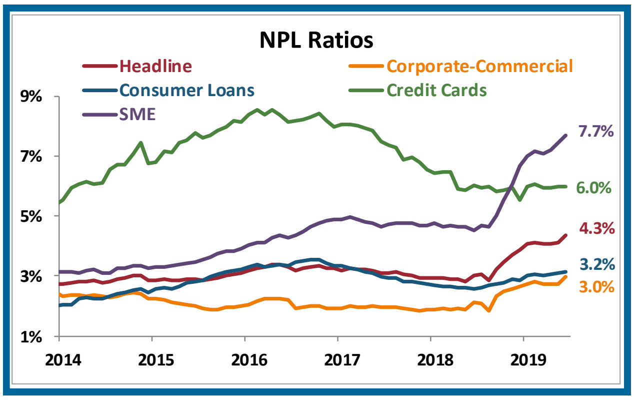
Loan to Deposit Ratios

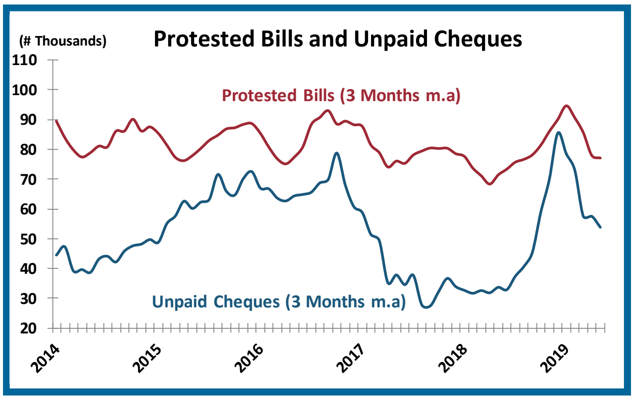




Total loan to deposit ratio (LDR) decreased to 111% while TL LDR increased to 144%.

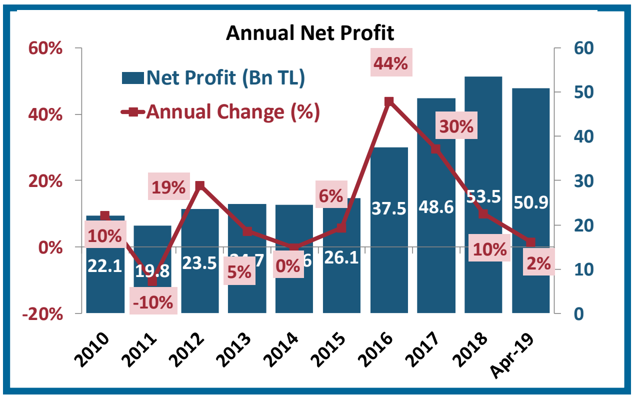
Loan Quality

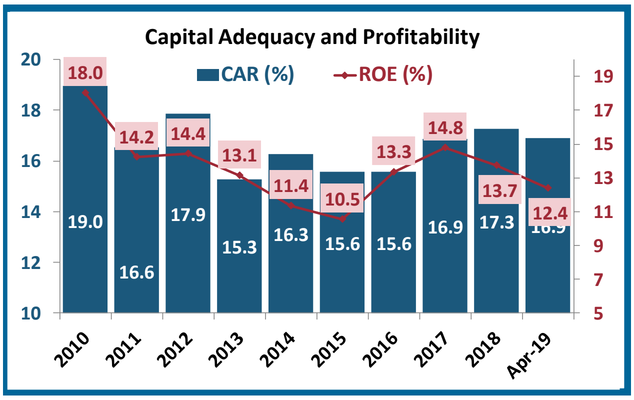




Headline NPL ratio for the banking sector rose moderately to 4.3% by the end of 1H19.

P & L





Banking sector's annual net profit increased marginally by 2% YoY to TL 51 bn in Apr'19. RoE of the sector decreased to 12.4%.