

# DenizBank Economic Update

March 2019

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

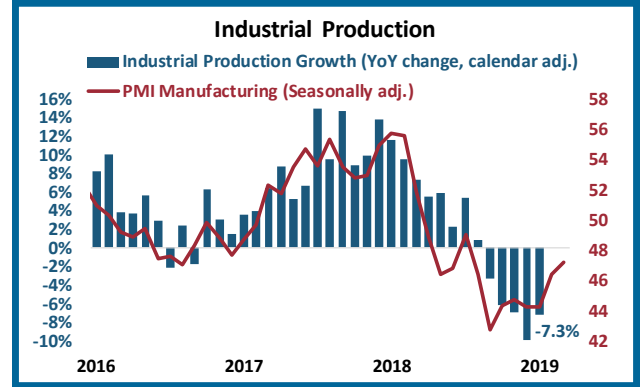
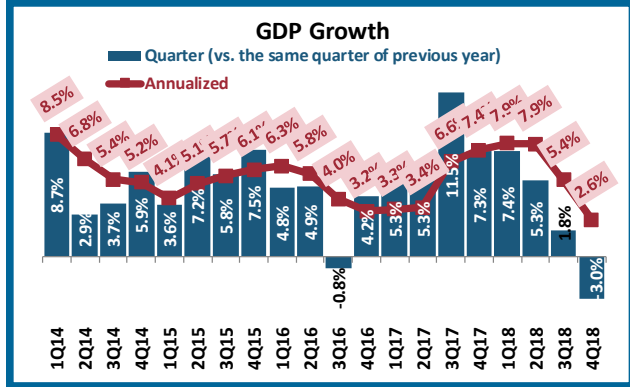


DenizBank Economic Research and Strategy

# DenizBank Economic Update

## Economy (I)

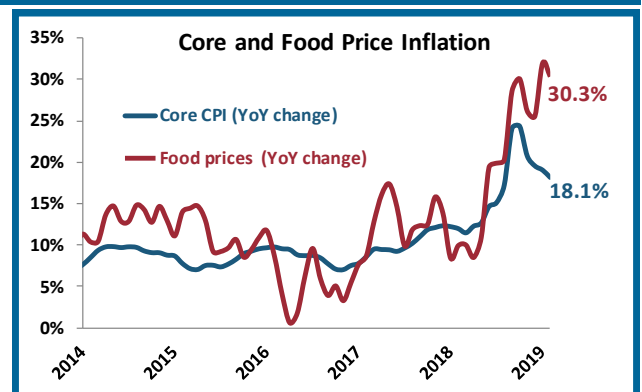
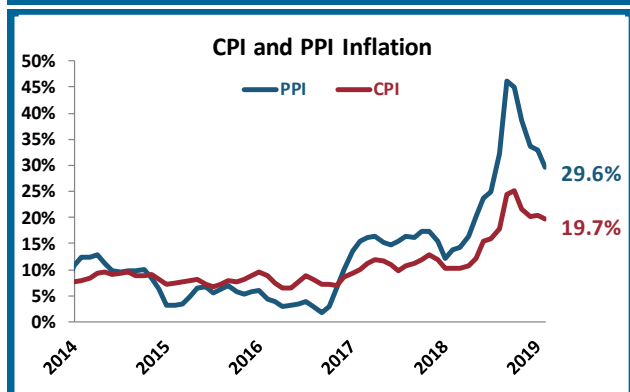
### Growth



### Contraction in economic activity continued in first quarter of 2019

- Turkish economy contracted 3% (market expectation: 2.5%) in the last quarter of 2018 compared to a year ago, dragging 2018 full-year growth rate down to 2.6%. On seasonally adjusted basis, GDP was down (-2.4% QoQ) for the second consecutive quarter, meaning Turkey entered to a technical recession for the first time since 2008.
- Private consumption and investments were down by 8.9% and 12.9% respectively in 4Q18, as loan growth and sentiment weakened drastically. Contribution from net exports prevented a sharper contraction in the economy as imports decreased by 24% while exports surged by 11%, thanks to robust external demand and competitive exchange rate.
- Leading indicators suggest contraction in economy continues in the 1Q19, albeit at a modestly slower pace. Industrial production (IP) decreased by 7.3% YoY in January, similar to 4Q18. PMI manufacturing increased to 8-month high (47.2) and capacity utilization rate rose to 5-month high (74.7%) in March supported by the pick up in credit growth, signaling a milder decline in IP in the rest of 1Q19. Yet, 6.7% decline in retail sales in January (4Q18: -7.3%), together with faltering auto and white goods sales in February demonstrate domestic demand remains muted.
- We expect consumption and investment to recover moderately in 2Q19, before turning positive in the 2H19 with the help of low base effect and looser financial conditions. Our 2019 growth expectation is 2%, with risks tilted to downside.

### Inflation



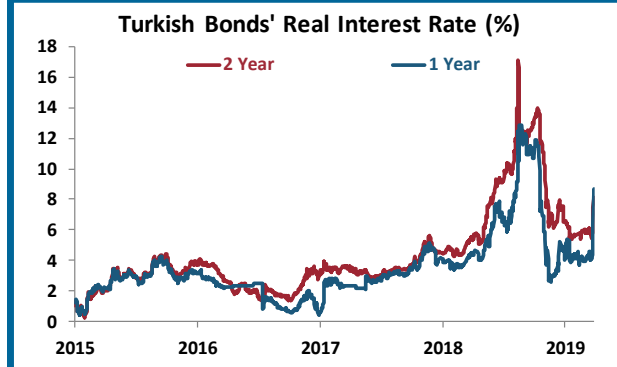
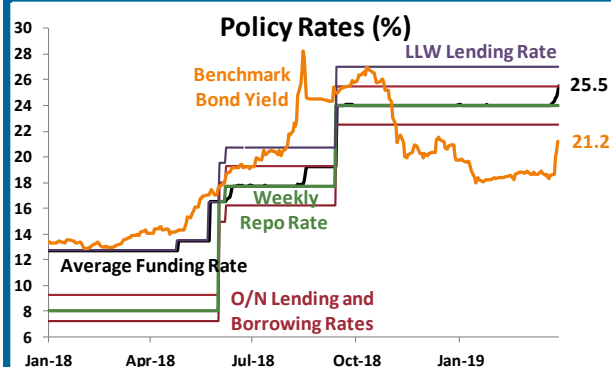
### Inflation decreased faster than anticipated

- Annual inflation retreated to 19.7% (market expectation: 19.9%) in February from 20.4% a month ago, thanks to the slowdown in food inflation and ongoing moderation in core inflation. Food inflation decreased from 32% to 30% on the back of high base effect, with very limited help from municipalities' vegetable sales. On the other hand, downward trend in underlying inflation is more significant as core inflation fell to 18.1% (from a peak of 24.3% in Oct'18) with the support of stabilization in TL and muted domestic demand. Cost-push pressures persist with producers' price inflation elevated at 29.6%.
- As tax cuts in durable goods were extended until the end of 2Q19, we expect inflation to remain around 19% before starting a rapid downward trend in 3Q19 toward single digits with the support of favorable base effect. Our 2019 year-end inflation expectation is 14%.

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## Economy (II)

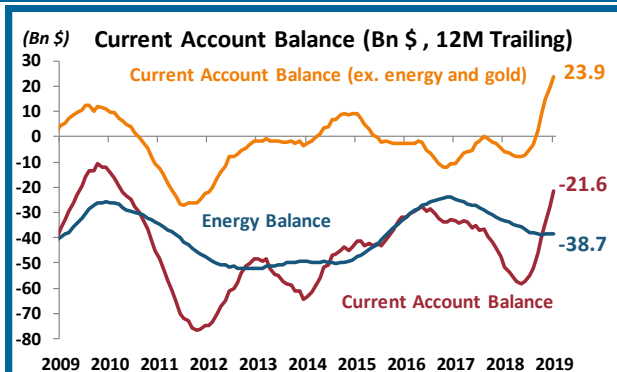
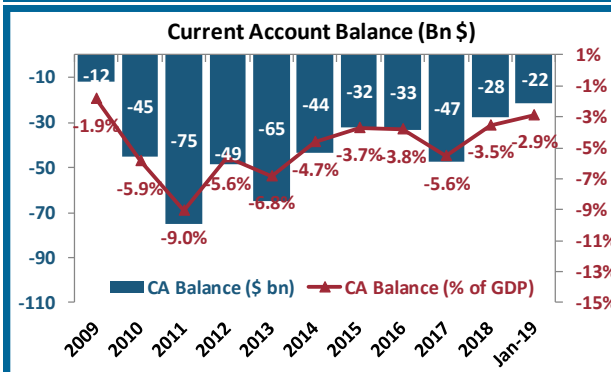
### Monetary Policy



### Central bank stepped up against rising volatility in TL, raising average funding rate up to 25.5%

- Central Bank (CB) kept the policy rate (one-week repo rate) unchanged at 24% in March meeting, as expected. More importantly, CB kept its hawkish policy guidance and tightening bias, reassuring against the odds off a rate cut before June meeting. However, as volatility in TL jumped once more in late March with TL depreciating as much as 10% within a few days, CB suspended funding through the one-week repo rate and increased the effective funding rate by 150 bps up to overnight rate of 25.5%.
- Regarding the weekly decreases in FX reserves (\$7.7bn) in March, CB repeated its commitment to reinforcing the reserves. In order to support FX reserves, CB raised the limit on local banks' FX swaps to 30% from 10% and suspended daily FX swap auctions, which supported a \$4.3 bn increase in gross reserves.
- Given CB's guidance and our inflation projections, we expect CB to avoid a rate cut in policy rate at least until June meeting. An unexpected surge in exchange rate volatility in 2Q19 may postpone monetary easing to 2H19.

### External Sector



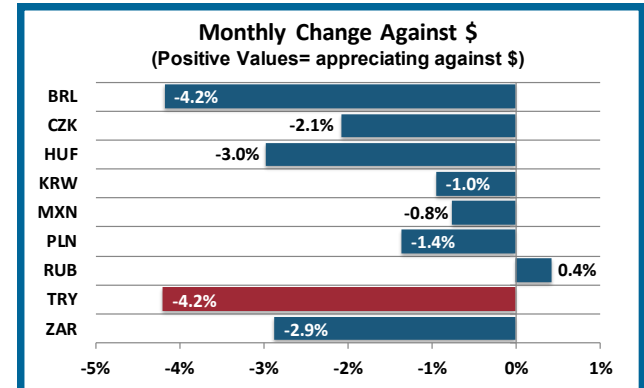
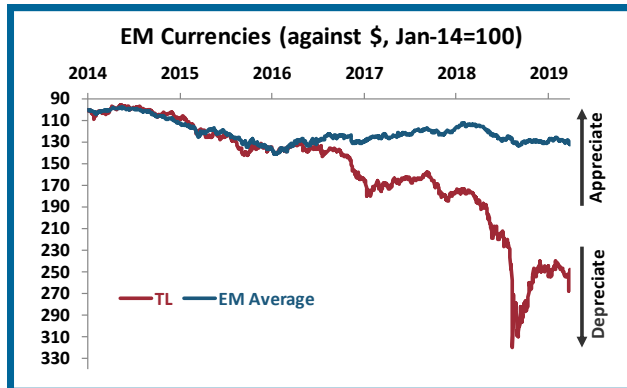
### Current account deficit shrank rapidly below 3% of GDP and set to improve further in 2019

- Sharp slowdown in domestic demand combined with robust external demand and depreciation in the real exchange rate, led to a rapid improvement in external balance as of 2H18. By January 2019, annual current account deficit (CAD) more than halved to \$22 bn (2.9% of GDP) from a peak of \$58 bn (7.3% of GDP) in 1H18, its lowest level since March 2010.
- As imports decreased by 23% YoY (consumption goods: -41%) since August due to weak domestic demand, core CAD (exc. energy and gold) gave an all-time high \$24 bn (3.2% of GDP) annual surplus in January. Moreover, annual energy deficit remained stable at \$38 bn as prolonged increase in oil prices came to an end in the last quarter of 2018.
- Following a capital outflow of \$17 bn in the 2H2018, Jan.'19 was characterized by an ample portfolio inflow of \$6.1 bn (\$4.5 bn bond issuance). Yet, on annual basis, net errors and omissions (\$20 bn) together with reserve drawdowns (\$11 bn annually) have been the main source of CAD financing. Portfolio outflows amounted to \$2 bn annually and banks' annual external debt roll-over ratios decreased to 75% with net debt repayments of \$17 bn.
- In February, trade deficit decreased further by \$3.6 bn with a sharp decrease in imports. As contraction in economic activity continues in 1H19, oil prices remain below 2018 levels (2018 avg. Brent oil \$72/bbl) we expect CAD to decrease c. 1.5% of GDP in 2019.

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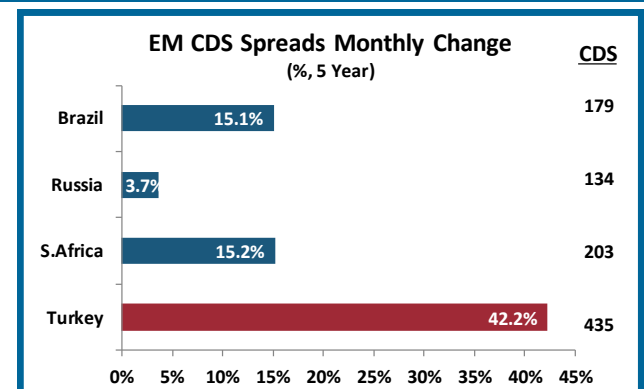
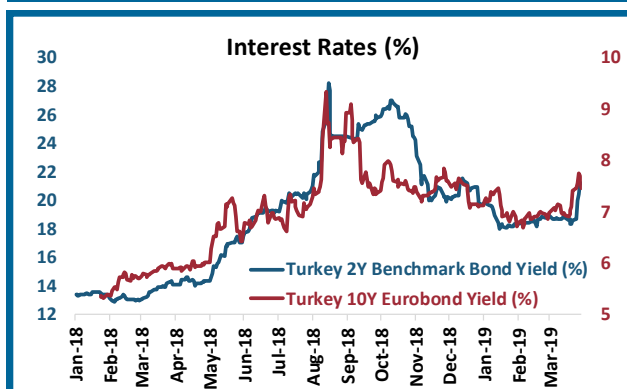
## Financial Markets

### Debt Market



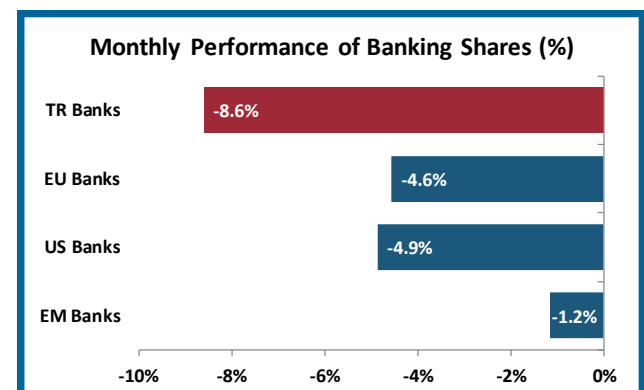
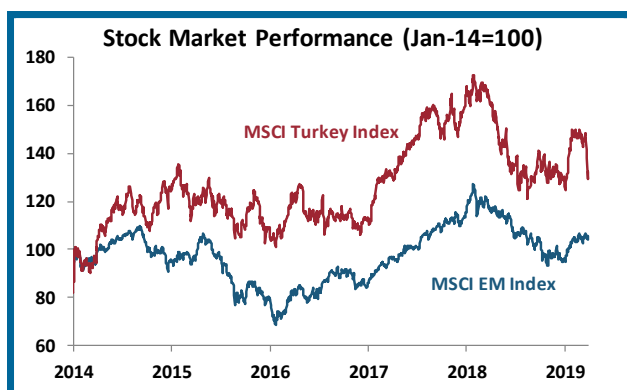
Turkish lira, which has been steady in the first two months of the year, has depreciated 4% in March, becoming the weakest performing EM currency on year-to-date basis after Argentine Pe-so.

### Currency Market



Turkey's risk premium and funding costs, which has been stable in the first two months of 2019 rose to late 2018 levels. Turkey's 2-year benchmark TL bond yield jumped 240 bps in March up to 21.2% while 10-year eurobond yield increased 60 bps to 7.5%.

### Stock Market

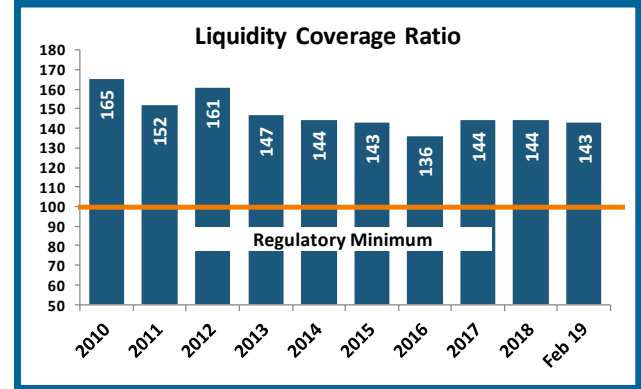
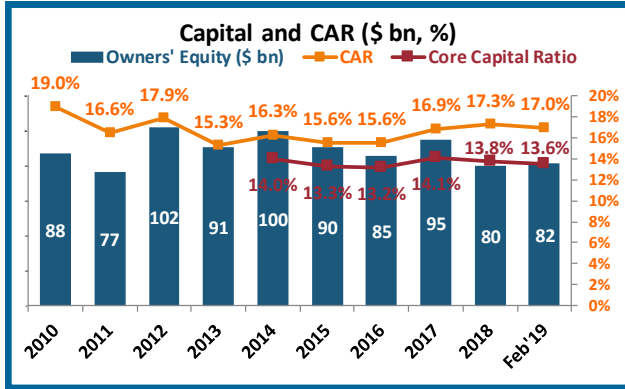


MSCI Turkey index was down 13% (in TL terms) in March, dragging year-to-date gains to 2% (vs. MSCI EM index +9.5%).

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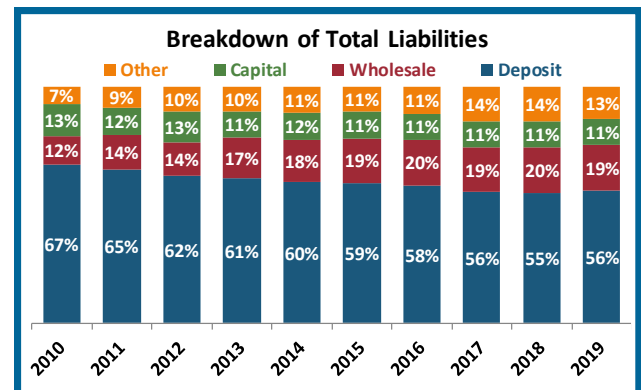
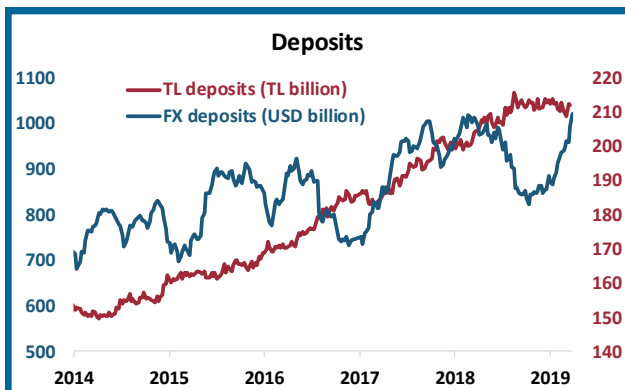
## Banking Sector (I)

### Capital



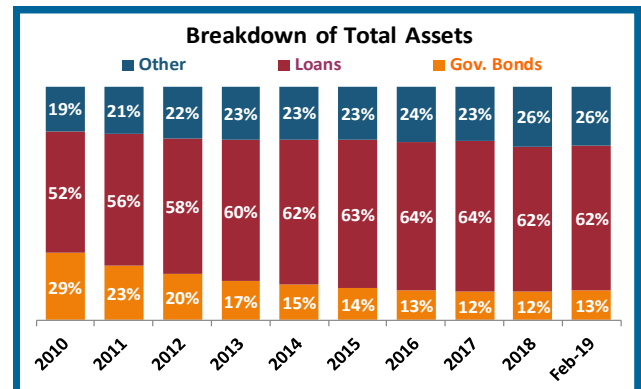
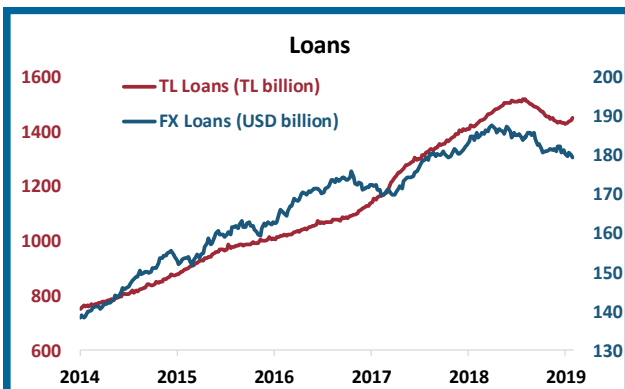
Turkish banking sector has a strong capital base. Capital adequacy ratio is at 17% as of 2018YE.

### Funding



FX deposits went up by 11% since the beginning of 2019 while TL deposits remained flat.

### Lending



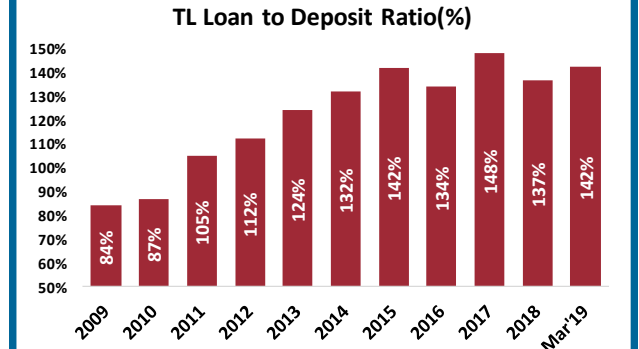
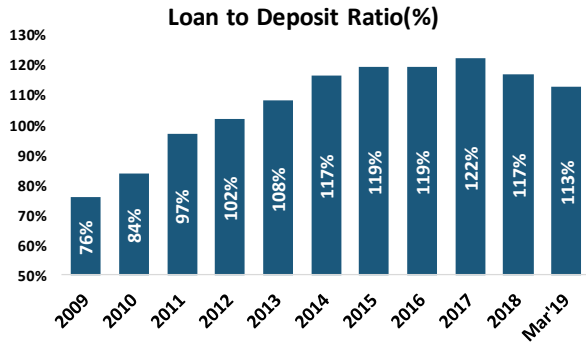
As loan growth picked up as of February, total loans increased 3.6% (1.5% net-of-currency) since the beginning of the year.



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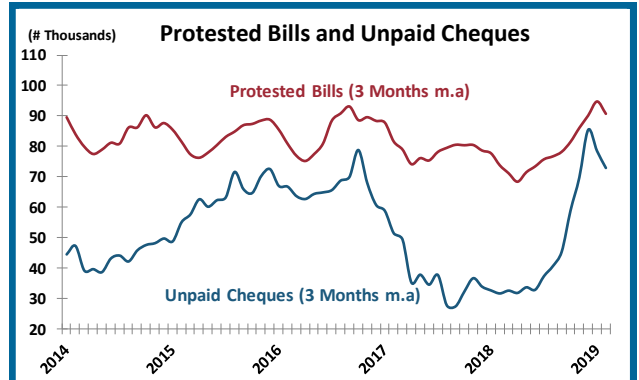
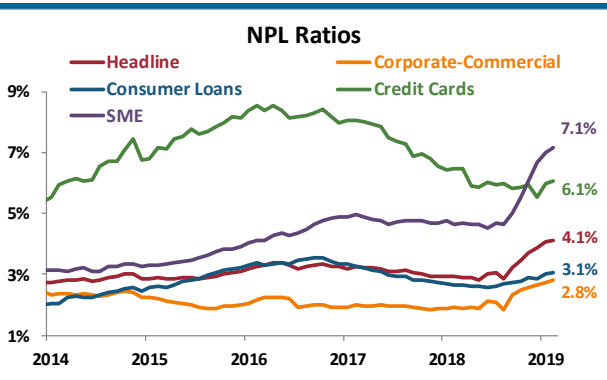
## Banking Sector (II)

### Loan to Deposit Ratios



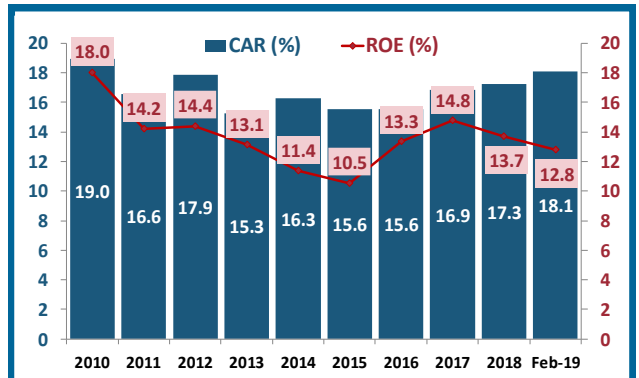
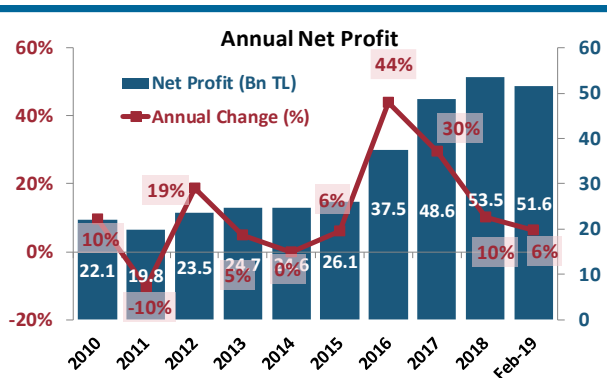
Total loan to deposit ratio (LDR) decreased to 113% while TL LDR 138%, respectively.

### Loan Quality



Headline NPL ratio for the banking sector rose moderately to 4.1% in Feb'19.

### P & L



Banking sector's annual net profit increased marginally by 6% YoY to TL 52 bn in Feb'19. RoE of the sector decreased to 12.8%.