DenizBank Economic Update

May 2019

- Economy
- Financial Markets
- Banking Sector

DenizBank Economic Research and Strategy

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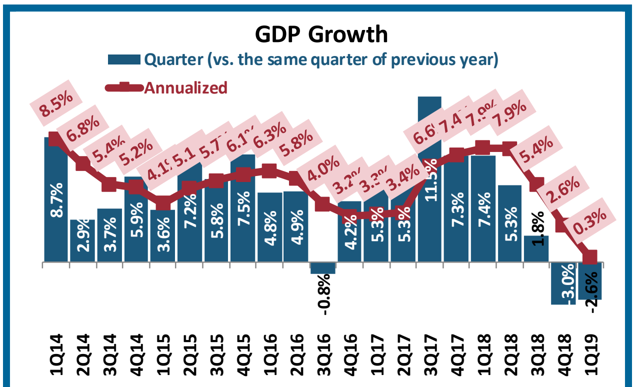
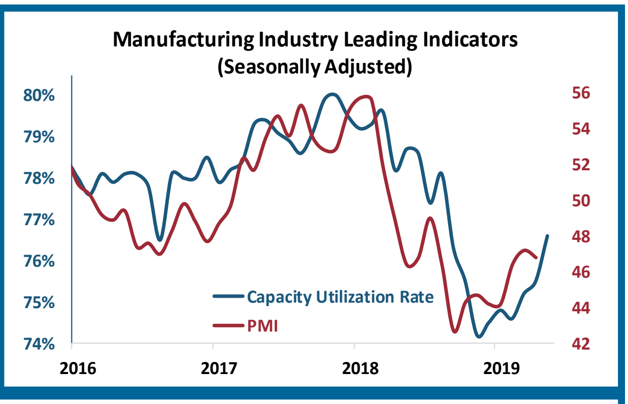
DenizBank Economic Update

Economy (I)

Growth





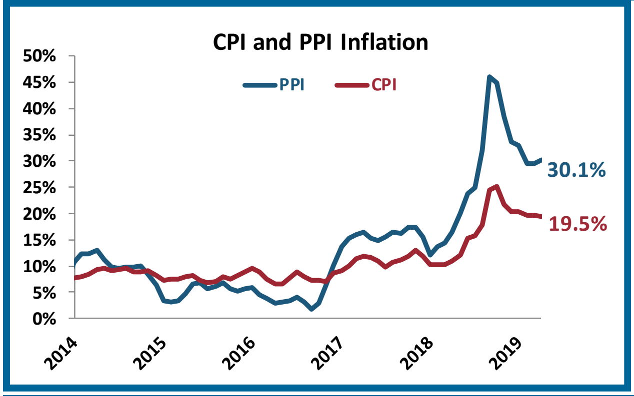
Economic activity has recovered moderately in the first half of 2019

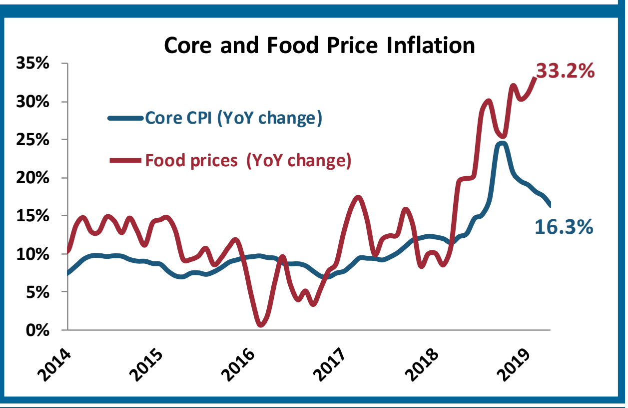
● Turkey's GDP contracted 2.6% YoY in first quarter of 2019 in line with our estimates, denoting a slight improvement on the 3% YoY contraction in the last quarter of 2018. GDP grew by 1.3% compared to 4Q18 on seasonally adjusted basis, following three consecutive quarters of QoQ contraction, meaning Turkey's first recession in the last decade was over as of 1Q19 according to its technical definition.

● Exports and government consumption (+7.2% YoY) have been the only positive contributors to growth in 1Q19, while private consumption continued to decline (-4.2% YoY, compared to -8.9% YoY preceding quarter). Contraction in investments was sharpest (-13% YoY) since 3Q09, becoming much more visible in construction. 29% collapse in imports while exports rose by 9% clearly demonstrates the shift in domestic demand away from imported goods, and rebalancing of the economy towards foreign demand.

● Preliminary data suggest annual contraction in GDP continues in 2Q19, albeit at a slower pace. PMI manufacturing increased to 46.8 in April from 45.9 in 1Q19, and capacity utilization rate rose to 9-month high (76%) in May, signaling a milder decline in industrial production. Yet, weakening in sentiment due to increased volatility in financial markets in the beginning of 2Q is visible in the reversal in confidence indices. As the pick-up in loan growth in 1Q19 has been temporary, government consumption cannot be sustained with expanding budget deficit, and financial conditions will remain tight for an extended period, recovery should be gradual. We expect annual growth to turn positive in 2H19 with the help of low base effect, and 2019 full-year growth rate to be 1%, significantly below its potential.

Inflation





Inflation remains flat in April with increased cost-push pressures

● Headline inflation remained roughly flat at 19.5% in April, below the market expectations of 20.4%. Sticky food inflation (33%) and higher energy prices were the main drivers of headline inflation, while core inflation moderated further to 16.5% from 17.5%, as underlying inflationary pressures were partially subdued by weak domestic demand. On the other hand, retreat in producers' price inflation (PPI) has reversed in April due to depreciation in TL (9% in March-April) and rise in energy prices. Cost-push pressures on headline inflation prevail with PPI inflation rising to 30.1%.

● We expect inflation to remain around 19% before starting a significant downward trend in August to low-teens on the back of favorable base effect. Our 2019 year-end inflation expectation is 15%, with upside risks due to exchange rate pass-through.

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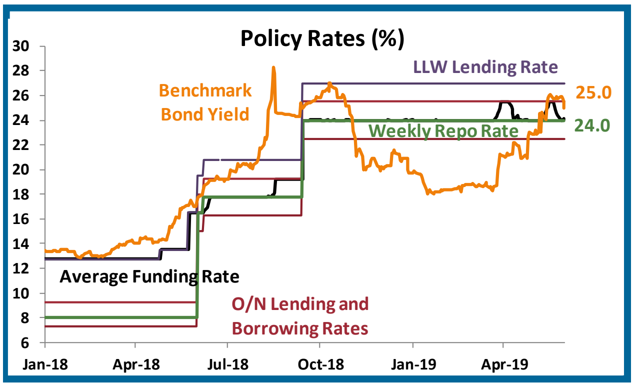
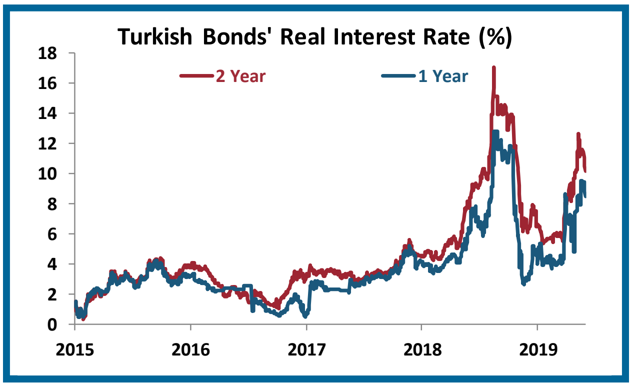
Economy (II)

Monetary Policy



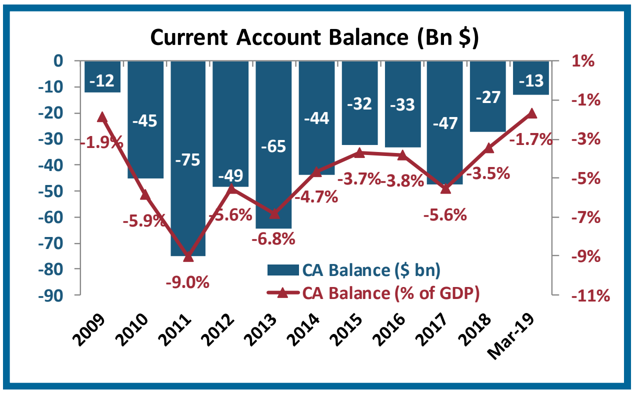


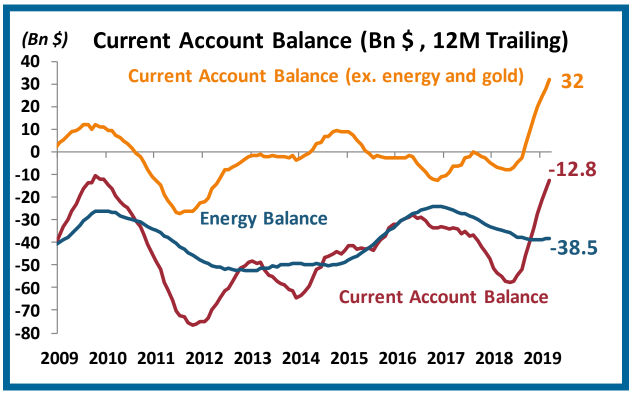
Central Bank keeps monetary policy on hold

● Central Bank (CB) keeps the policy (one-week repo) rate unchanged at 24% since September. In its latest statements in April meeting and quarterly inflation report, CB reiterated its commitment to maintaining tight policy stance until inflation outlook improves significantly and reinstated the tightening bias. Indeed, as volatility in TL jumped once more in early May, CB suspended funding through the policy rate and increased the effective funding rate by 150 bps up to overnight rate of 25.5% temporarily for two weeks. Given CB's hawkish guidance, prolonged volatility in TL and our inflation projections, we expect CB to keep tight monetary stance at least through summer 2019.

● Financial authorities kept implementing additional measures to ensure stability in markets against Turkey's rising risk premium. In May, CB raised the reserve requirement ratios for FX deposits by 300 bps in total, and lowered the ratio of TL reserve requirements that is allowed to be kept in FX from 40% to 30%. Banking regulator imposed one-day settlement delay for large FX purchases by individuals and 0.1% tax was reintroduced on FX transactions in order to prevent speculative transactions. Additional measures to limit volatility are expected to remain market friendly, as echoed many times by authorities.

External Sector





External rebalancing continues with current account deficit shrinking rapidly towards 1% of GDP

● Sharp slowdown in domestic demand combined with increased competitiveness of exports led to a rapid improvement in Turkey's external balances starting in 2H18. While imports decreased by 21% YoY since August following the sharp depreciation of TL, exports increased by 5%. Moreover, steadily rising net tourism and transportation income compensated for most of the remaining external trade deficit. As a result, annual current account deficit (CAD) decreased to $13 bn (1.7% of GDP) in 1Q19 from a peak of $58 bn (7.3% of GDP) in 1H18, its lowest level in nine years. Current account surplus excluding energy and gold reached record high level of $32 bn (%4.3 of GDP).

● On annual basis, FDI inflows ($ 10 bn), reserve drawdowns ($9 bn) and net errors and omissions ($8 bn) have been the main source of CAD financing and compensated for banks' debt repayments and deposit ouflows. Despite $9 bn eurobond issuance in 1Q19, annual portfolio inflows remain weak at $4 bn (compared to $ 23 bn same period last year).

● In April, trade deficit decreased further by $4.0 bn suggesting CAD shrinking towards 1% of GDP. As domestic demand remains muted and oil prices remain at 2018 levels until 4Q19, we expect CAD/GDP to decrease further below 1% before finishing the year at 1.5%

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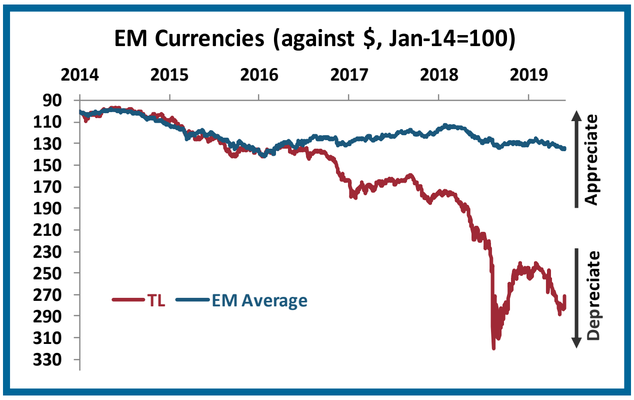
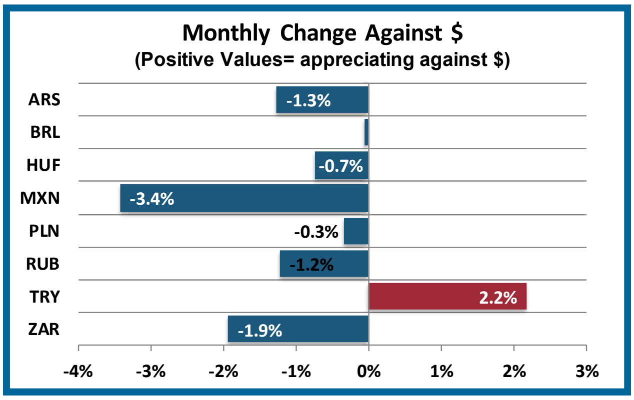
Financial Markets

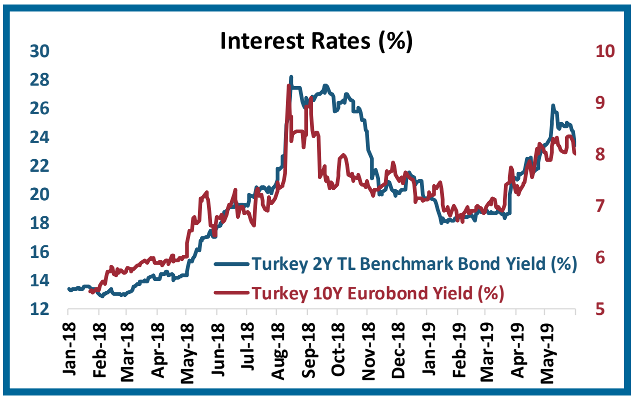
Currency Market

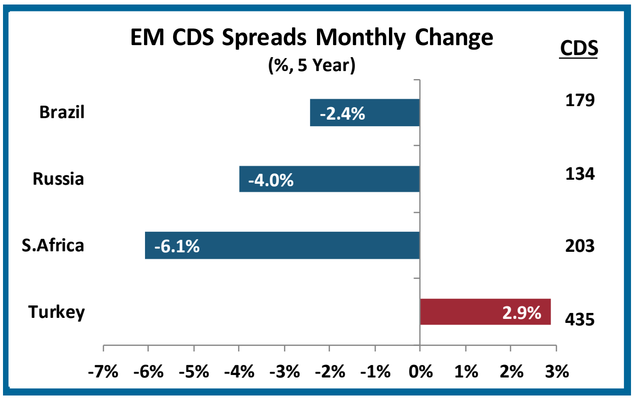




Recovering some of its losses in May, Turkish lira has depreciated by 9% against USD since the beginning of March, becoming the weakest performing EM currency on year-to-date basis after Argentine Peso.

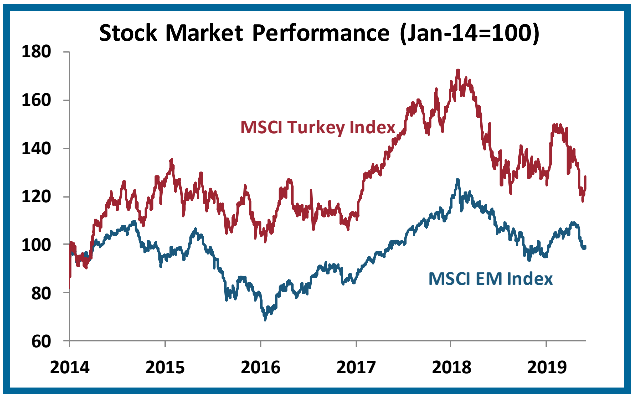
Debt Market

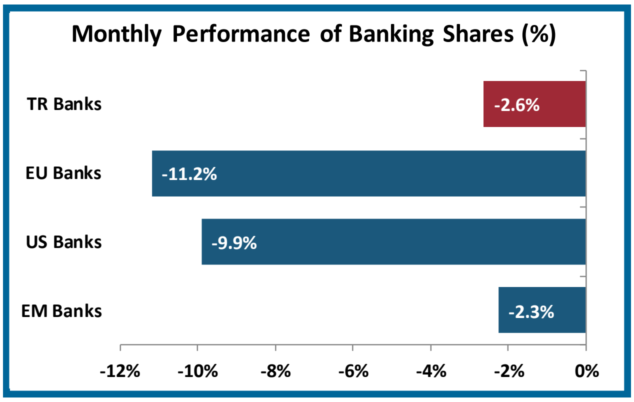




Turkey's risk premium and funding cost rose to October 2018 levels. Turkey's 2-year TL bench-mark bond yield increased 500 bps up to 25% 10-year eurobond yield rose to 8.0%.

Stock Market





MSCI Turkey index was down 1% (in TL terms, 11% in USD terms) since the beginning of the year, underperforming EM peers (MSCI EM index was up 3%).

Data retrieved from Bloomberg as of 13:00 (GMT + 3), 02.06.2019

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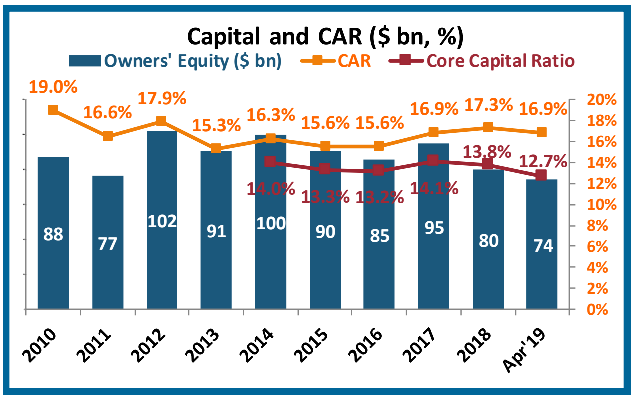
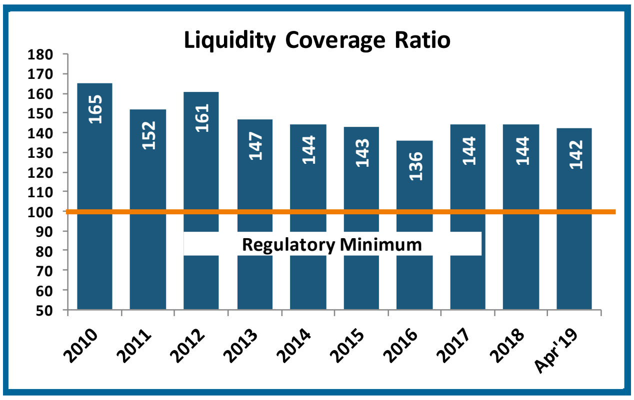
Banking Sector (I)

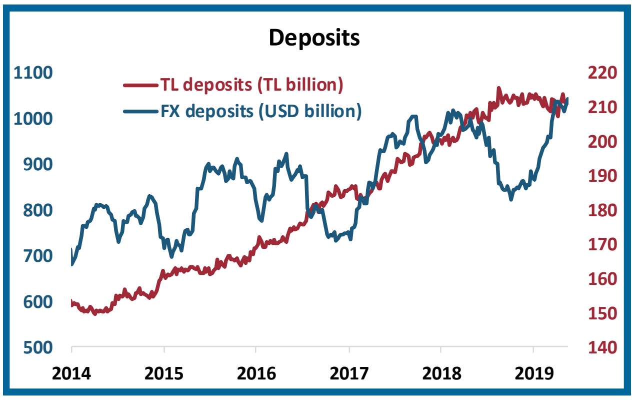
Capital

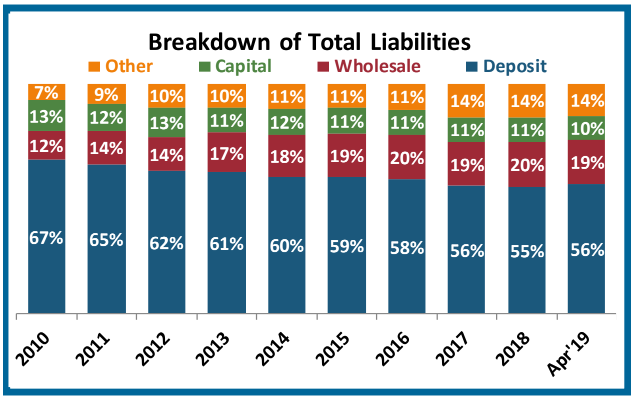




Turkish banking sector has a strong capital base. Capital adequacy ratio is at 16.9% as of Apr'19.

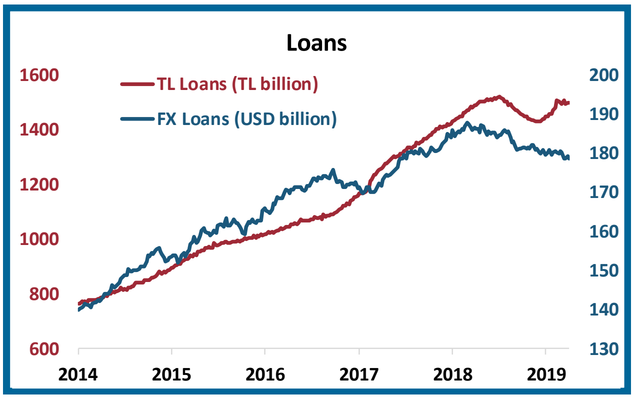
Funding

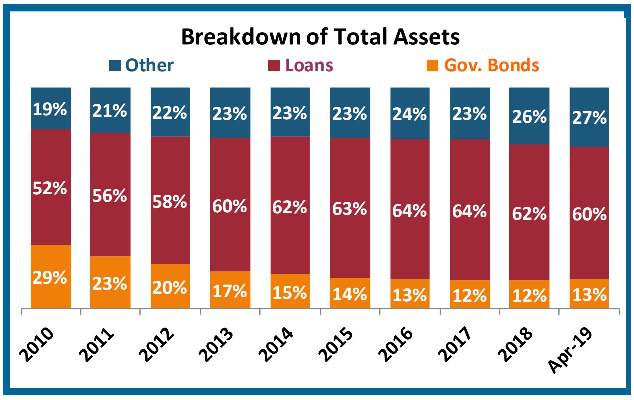




FX deposits went up by 13% since the beginning of 2019 while TL deposits decreased by 1%.

Lending





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

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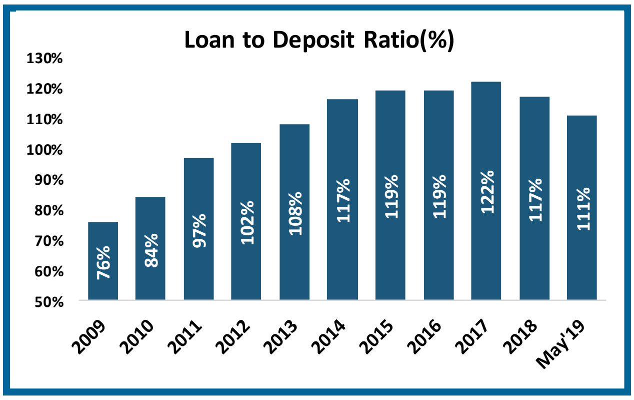
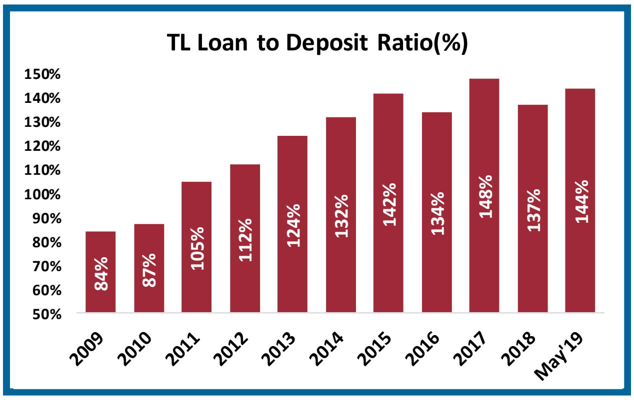
Banking Sector (II)

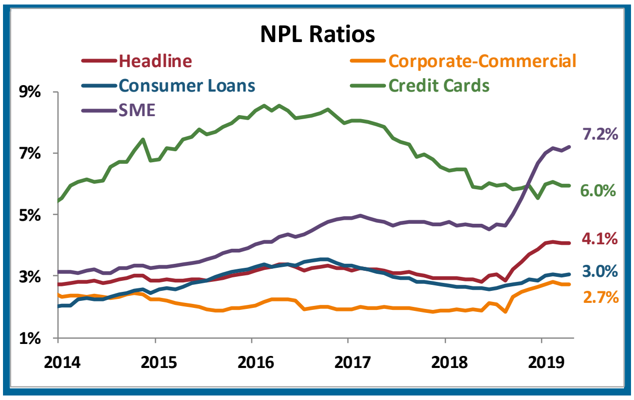
Loan to Deposit Ratios

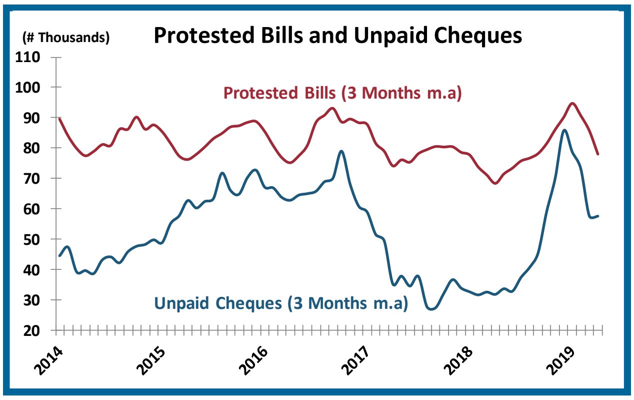




Total loan to deposit ratio (LDR) decreased to 111% while TL LDR increased to 144%.

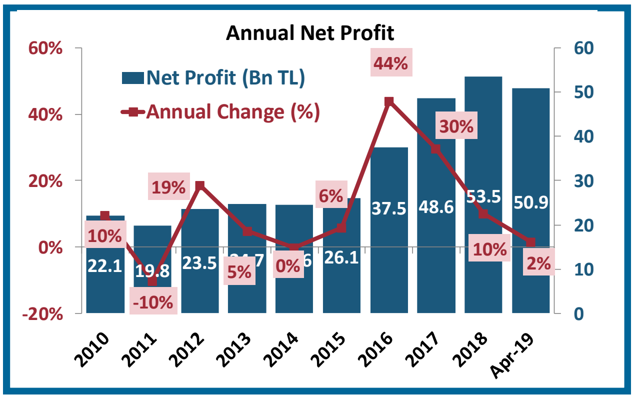
Loan Quality

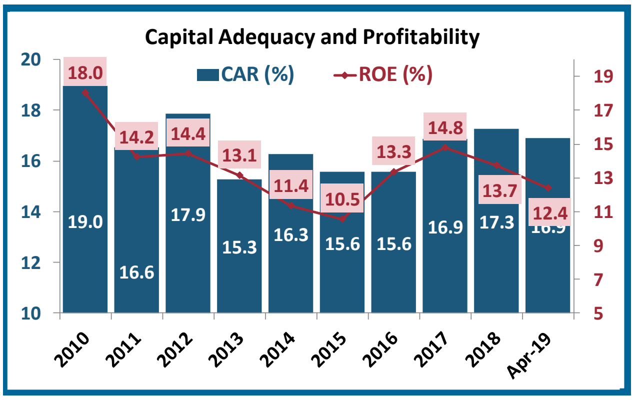




Headline NPL ratio for the banking sector rose moderately to 4.1% in as of Apr'19.

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%.