DenizBank Economic Update

September 2018

- Economy
- Financial Markets
- Banking Sector

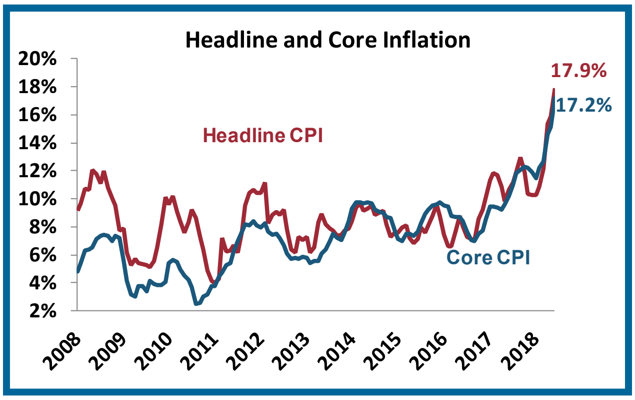
Economic Research and Strategy
Saruhan Özel, Ph.D.
Ezgi Gülbaş
Deniz Bayram

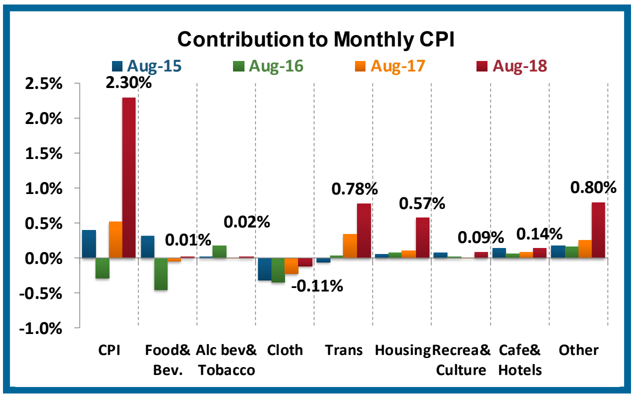
DenizBank Economic Research – (90) 212 348 20 00 or ekonomikarastirmalar@denizbank.com

DenizBank Economic Update

Economy (I)

Inflation





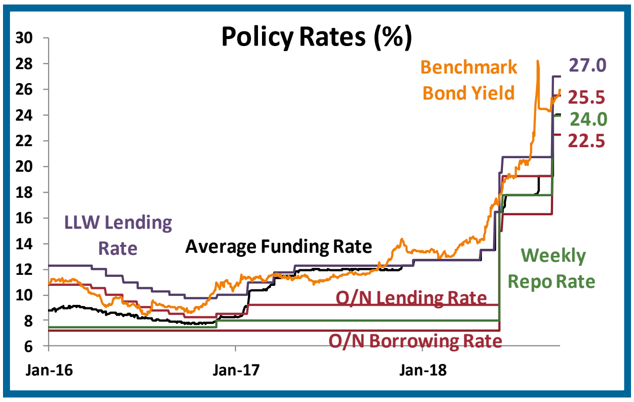
Inflation rose sharply in August with continued FX pass-through...

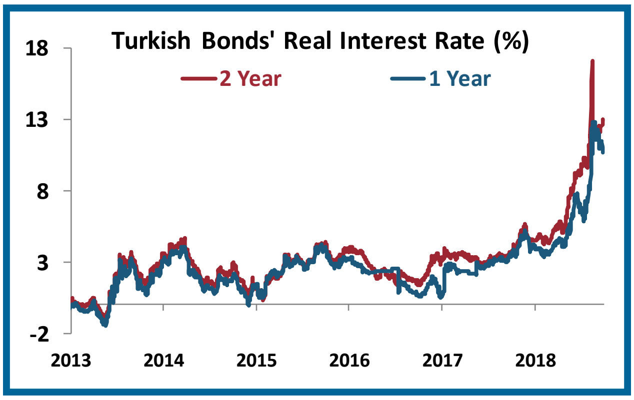
● In August, consumer prices rose sharply by 2.3% MoM above the market expectations of 1.8%. FX weakness was the main reason behind the sharp increase in inflation. Most significant contribution to monthly inflation came from core goods and energy stemming from FX-pass through, while food prices remained flat due to the high base effect.

● August imprint took annual inflation to 17.9% from 15.8%, a new all time high of 2003 based CPI index. Core inflation accelerated to 17.2% in line with the depreciation led increase in core good prices (23% YoY), suggesting further deterioration in pricing behaviour. Moreover, 26% MoM plunge in TL against USD in August had immediate impact on producers' prices, as evident in the 6.6% monthly PPI inflation which pushed annual PPI inflation to 32.1%.

● Given the sharp depreciation in TL, FX pass-through on headline inflation is likely to accelerate in the coming months. Aggravated with administrative price hikes in electricity, natural gas and oil, we expect inflation to exceed 20% in September and remain elevated above 20% until mid-2019.

Monetary Policy





Central Bank exceeded market expectations in its September meeting...

● Central Bank (CB) responded to the deterioration in inflation outlook by delivering a 625 bps hike in the policy rate (1-week repo rate) in the September meeting, bringing the policy rate to 24% from 17.75%. This corresponds to a 475 bps hike in the effective funding rate (as funding had been temporarily provided via O/N lending at 19.25%), significantly above the market expectations of 150 bps.

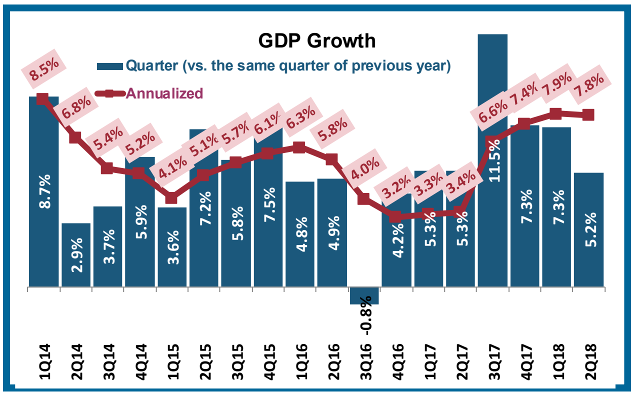
● The tone of the statement was hawkish, acknowledging the significant risks on the pricing behavior. CB stated that the tight monetary stance will be maintained decisively until inflation outlook displays a significant improvement and further monetary tightening will be delivered if needed.

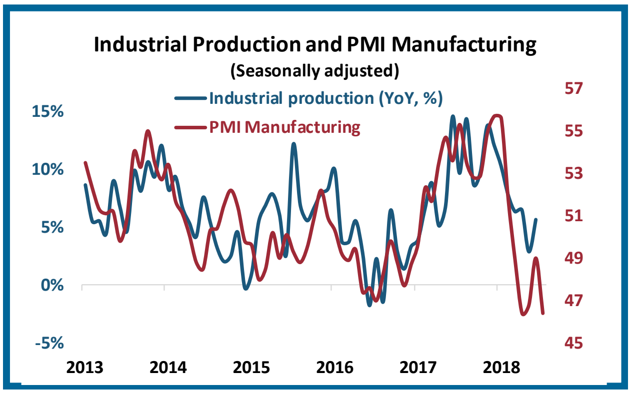
● We think that this month's rate hike, which brings the ex-post real policy rate to 5%, builds an appropriate real policy buffer for the climbing inflation and we do not expect any more rate hikes. In case of a surprise increase in inflation and immediate need for further tightening, CB may implicitly raise the funding cost by up to 300 bps by switching to O/N or late liquidity window lending. Given the elevated inflationary expectations, we expect the CB to hold on to its tight monetary policy at least until mid-2019.

DenizBank Economic Update

Economy (II)

Growth





Economic activity rebalances in second half of 2018...

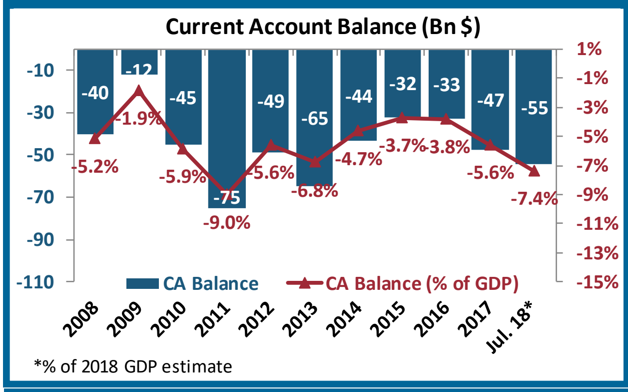
● In 2Q18, Turkey's economic growth was strong at 5.2% YoY (7.8% annualized), albeit slower than previous quarters. QoQ growth moderated to 0.9%, lowest level since 3Q16, signalling the economy has entered into the long-waited adjustment process.

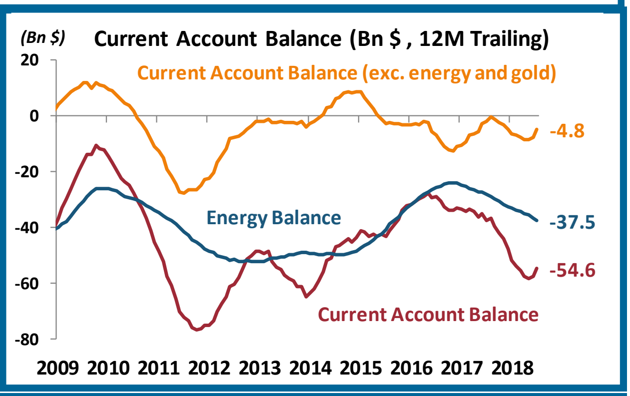
● Private consumption (+6.3% YoY) continued to be the main driver of growth while investments (+3.8% YoY) lost momentum compared to 1Q18. Deceleration in machinery and equipment investments (+0.6% YoY) was particularly significant. Due to the sharp slowdown in imports, net exports made a positive contribution to growth.

● Leading indicators suggest a more evident downturn in economic activity in 3Q18. While industrial production was still robust in July (+5.2% YoY), manufacturing PMI was below the 50 threshold in August (46.4) for the fifth consecutive month and capacity utilization rate decreased to 75.8%, lowest in four years. Imports, 85% of which consists of capital and intermediate goods, declined 22% in August indicating a significant slowdown in industrial production. Moreover, automotive and white goods sales were down by 51% and 22%, respectively that demonstrates the contraction in domestic demand.

● As credit growth turns negative with higher interest rates and fiscal measures kick in, we expect a contraction in economy in 4Q18. Our 2018 full year growth expectation stands at 2.0%.

External Sector





External deficit is on a downward trend...

● As the economy entered an adjustment period in 3Q18, external balances started to improve. In July, 12-month trailing current account deficit (CAD) decreased to $54.6 bn (7.3% of 2018 GDP forecast) from $57.5 bn in June, recording the largest improvement since 2015 (2017: $47.4 bn).

● Due to the slowdown in domestic demand, core CAD (exc. energy and gold) which has been rising since mid-2017, declined to $4.8 bn annually in July. While upward trend in energy deficit continued due to the higher oil prices (up YoY by 34% to $37.5 bn), net gold imports decreased to $12.3 bn from its all-time high ($14.3 bn) in May.

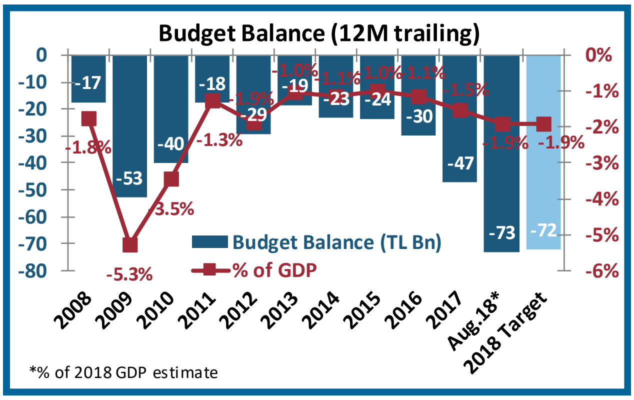
● On the financing side, loans provided from abroad by corporates ($8.5 bn annually) and foreign deposits ($4.9bn) together with reserve assets ($8.7 bn) have been the main source of CAD financing. Portfolio investments continued to decrease ($6.1 bn) and FDI ($7.2 bn) remained to be weak.

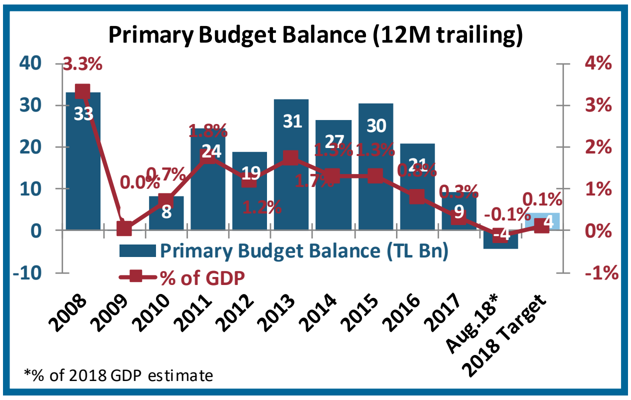
● Sharp decrease in imports in August (23%) signals acceleration of the downward trend in external deficit. Supported by further slowdown in domestic demand, stronger exports due to the weak currency and higher tourism revenues, we expect CAD (% of GDP) to be below 6% at end-2018.

DenizBank Economic Update

Economy (III)

Public Sector





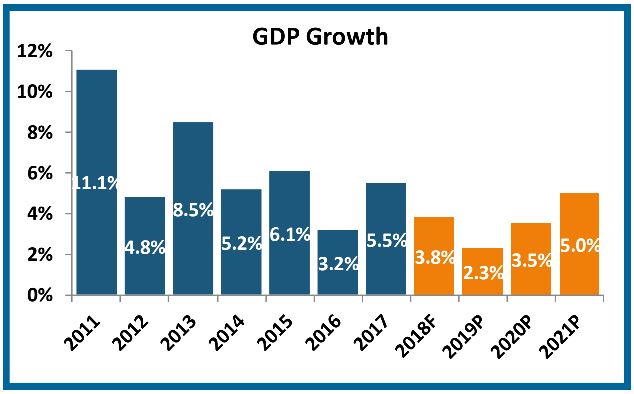
Government commits to fiscal prudence in the last quarter of 2018...

● In August, central government budget deficit rose to TL 5.8 bn compared to TL 0.9 bn in August 2017, due to the TL 12 bn benefit handed out to pensioners as an election promise. 12 months trailing budget deficit increased to TL 73 bn (1.9% of 2018 GDP forecast) from TL 47.4 bn (1.5% of GDP) in 2017.

● Increase in the budget deficit since the beginning of the year was mainly due to the TL 24 bn pensioner benefits, increase in the capital spending and rising interest expenses particularly since May. In the same period, increase in the indirect tax revenues were limited due to weakening demand and new regulation curtailing special consumption tax on oil.

● As budget expenditures accelerated before the general elections in June, budget deficit reached TL 72 bn year-end target by August. Yet government commits to fiscal consolidation in rest of the year, setting the 2018 budget deficit target in New Economic Programme to TL 72 bn. Treasury and Finance Minister Albayrak announced that TL 35 bn revenues and savings were ensured for the rest of the year to meet the 1.9% budget deficit and 0.1% primary surplus targets.

New Economic Program



New Economic Program Targets

	2018	2019	2020	2021
GDP Growth	3.8%	2.3%	3.5%	5.0%
GDP (Bn TL)	3741	4450	5150	5742
GDP (Bn $)	763	795	858	926
Inflation (CPI, %)	20.8%	15.9%	9.8%	6.0%
Current Account Deficit (% GDP)	-4.7%	-3.3%	-2.7%	-2.6%
Budget Deficit (% GDP)	-1.9%	-1.8%	-1.9%	-1.7%
Primary Budget Balance (% GDP)	0.1%	0.8%	1.0%	1.3%

Turkey announced the New Economic Program for 2019-2021…

Growth: In the New Economic Program (NEP, formerly Medium-Term Program) authorities acknowledge the slowdown in the economy and settles for a growth target of 2.3% for 2019. Private consumption is expected to slowdown and investment spending is to decline due to sharp decrease in public investments in 2019. Government expects growth to be moderate (%3.5) in 2020 as well, before picking up in 2021.

Inflation: NEP's 2019 inflation expectation is at 20.8%, in line with the market expectations. NEP foresees a gradual decline in inflation (15.9% in 2019), which is expected to fall to single digits by the end of 2020.

Current account balance: In accordance with the soft landing in the economy, NEP targets an adjustment in external balances with CAD decreasing to 3.3% in 2019 and stabilizing below 3% by 2021.

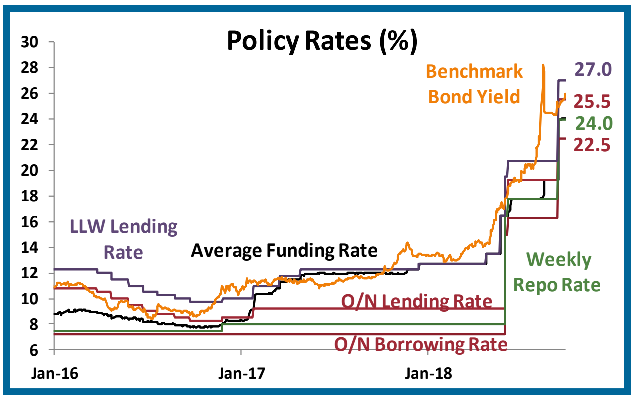
Budget balance: NEP prioritizes return to fiscal discipline by targeting the budget deficit below 2% and primary surplus gradually rising above 1% by 2021. NEP targets a primary surplus of 0.8% in 2019 with the implementation of fiscal measures totaling TL 76 bn (1.7% of GDP, 60 bn from expenditure cuts and TL 16 bn from higher revenues). Peaking at 31.1% in 2018, gross government debt/GDP is expected to remain low below 30% through 2019-2021.

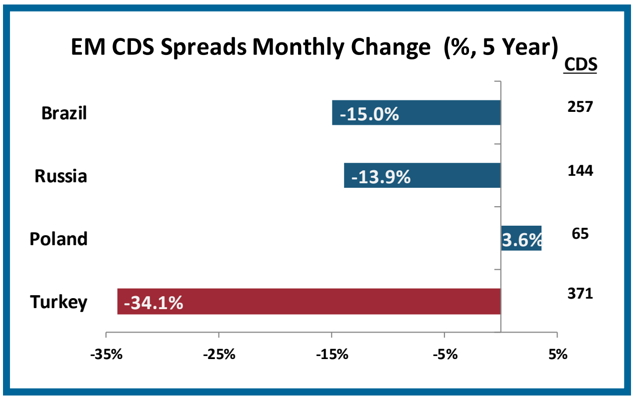
September 2018

DenizBank Economic Update

Financial Markets

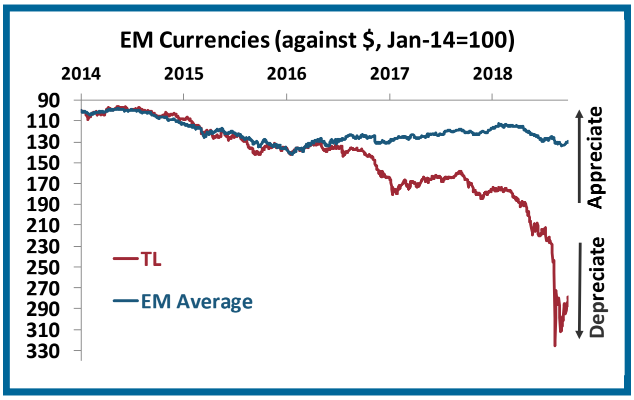
Debt Market

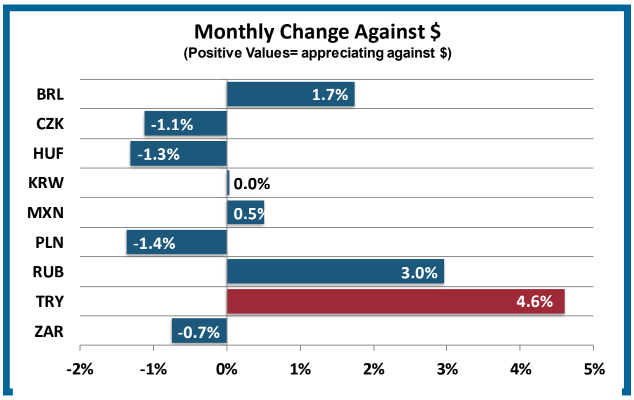




Turkey's CDS decreased to 370 in September from its 10-year high (560) in August. 2-year benchmark bond yield increased by 1150 bps since May to 25.8%

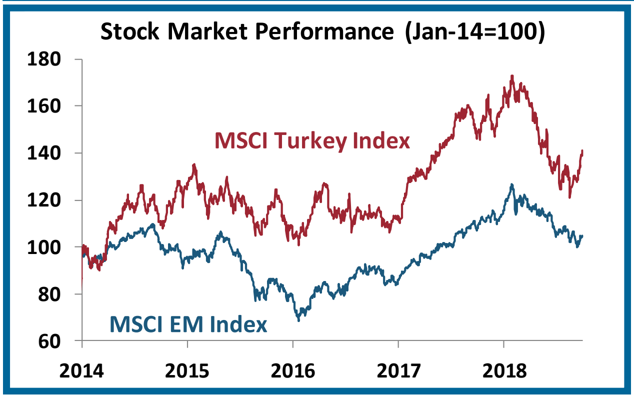
Currency Market

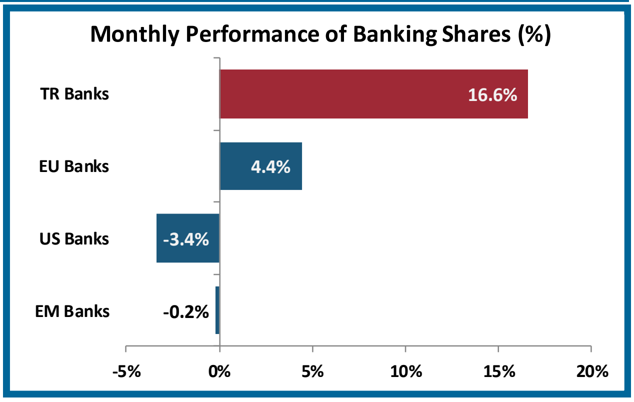




Following the 26% plunge against USD in August, TL appreciated by 4.6% in September thanks to 625 bps rate hike in policy rate and announcement of a prudent economic program. With 37% depreciation since the beginning of the year, TL remains as the weakest performing currency after Argentine Peso.

Stock Market





MSCI Turkey index was up MoM by 10% (in TL terms) while MSCI EM index remained flat. However, MSCI Turkey index was down by 14% YtD, underperforming EM peers (down by 9%).

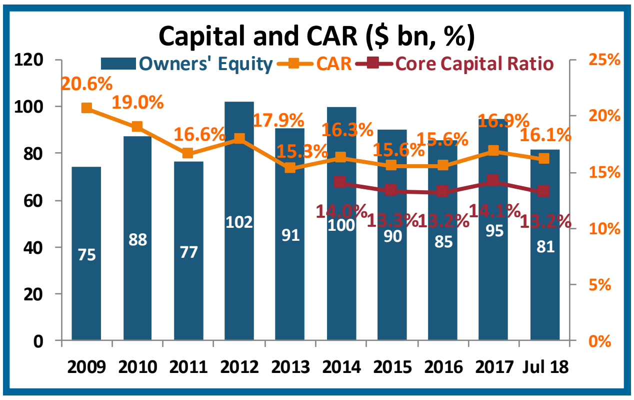
Data retrieved from Bloomberg as of 14:00 (GMT + 3), 28.09.2018

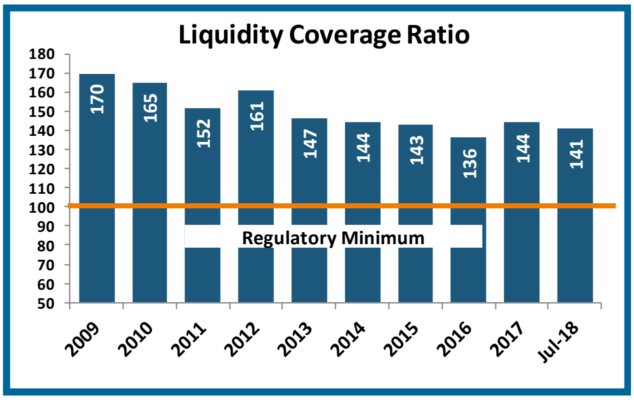
September 2018

DenizBank Economic Update

Banking Sector (I)

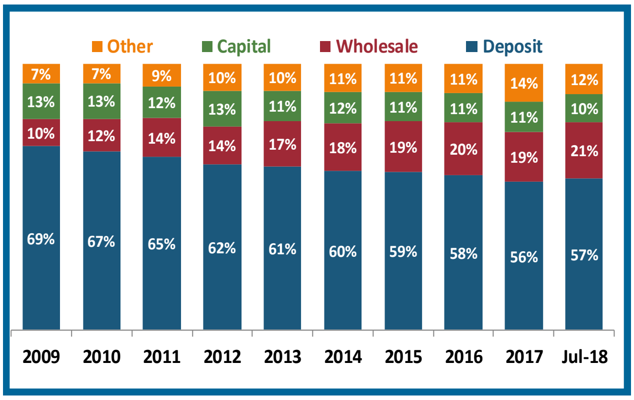
Capital

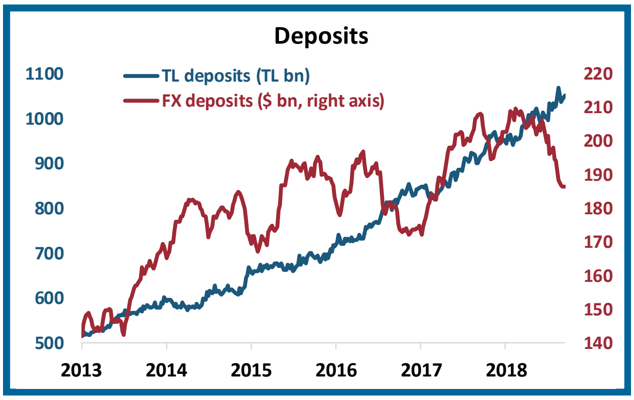




Turkish banking sector has strong capital base. Capital Adequacy Ratio is at 16.1% as of July 2018.

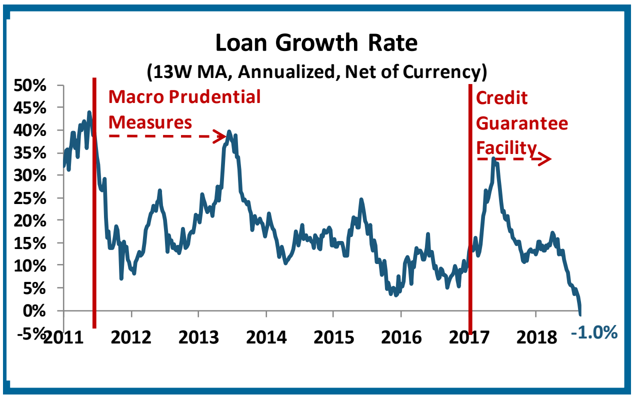
Funding

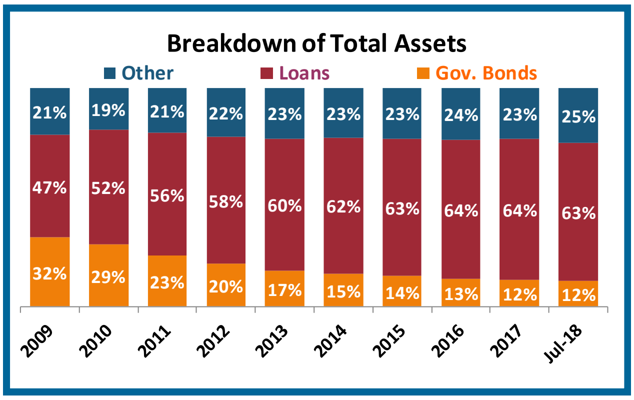




Deposits went up YoY by 35% (2.8% net-of-currency) to TL 2.2 trillion as of September 14th. Share of deposits in funding is stable at 57%.

Lending



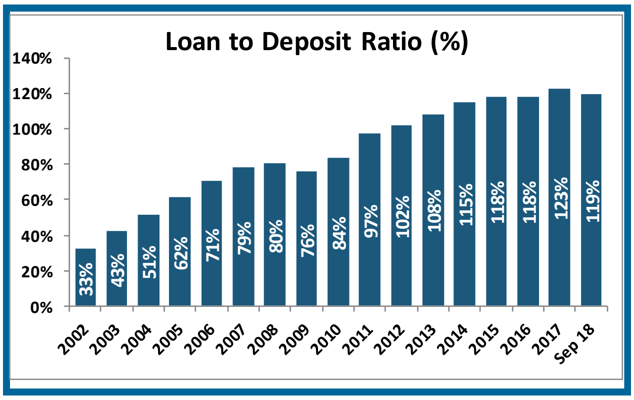


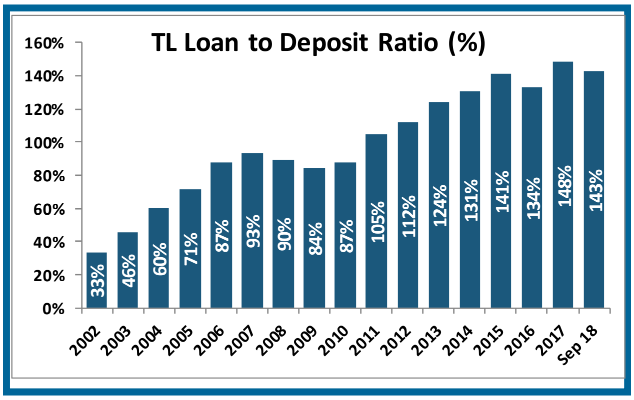
Annualized 13 week average net-of-currency loan growth turned to negative on the week of September 14th.

DenizBank Economic Update

Banking Sector (II)

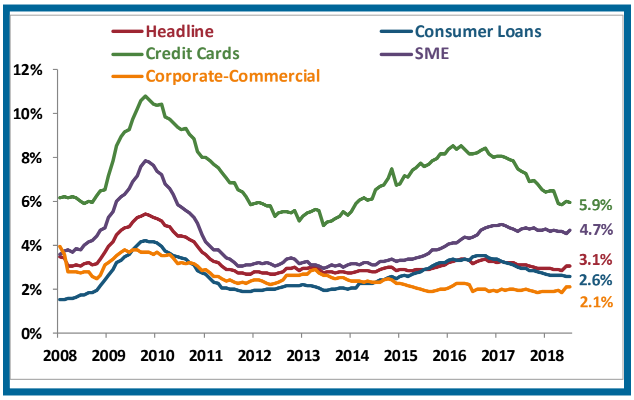
Loan to Deposit Ratios

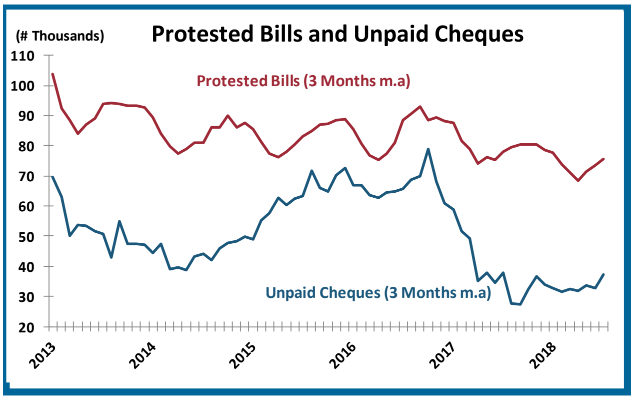




Loan to deposit ratio (LDR) and TL LDR are at 119% and 143%, respectively.

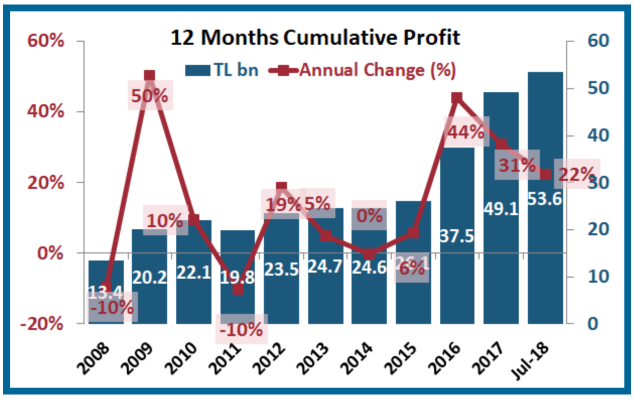
Loan Quality

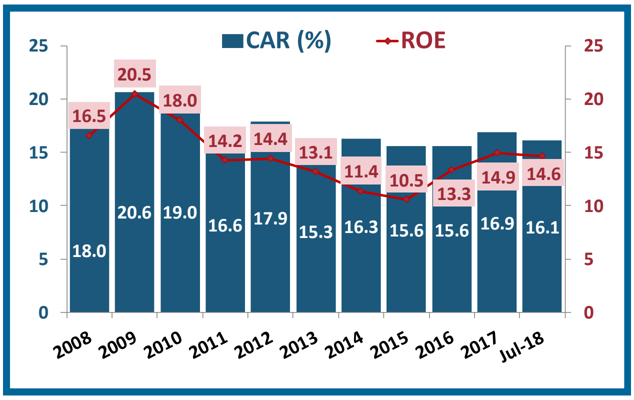




Headline NPL ratio for the banking sector is stable at 3.0%.

P & L





As of end July 2018, 12 months cumulative profit increased YoY by 22% to TL 54 bn. CAR of the sector remains strong at 16.1%.