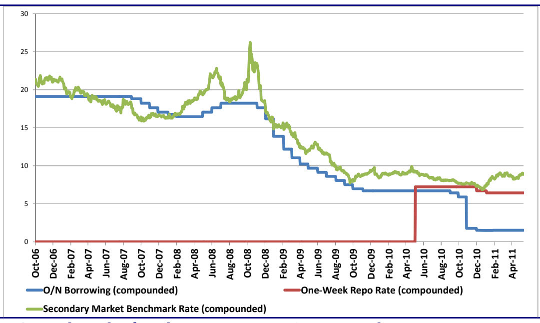
Macro Update

Turkey Weekly Macro Comment

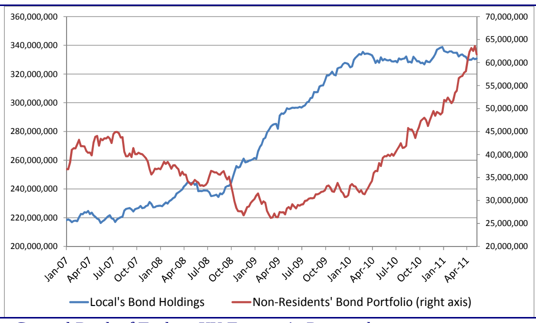
30 May 2011

Bond Rates vs O/N



Source: Central Bank of Turkey, YK Economic Research

Domestic & Foreign Bond Portfolios



Source: Central Bank of Turkey, YK Economic Research

More Divisions and Alliances Out of the Closet

- Election is only two weeks away and continuation of the single party government is almost a sure bet. Whether the AKP will grab the 367-seat majority is the million dollar question the answer to which depends on the nationalist MHP's test with the 10% threshold.
- A very interesting development is taking place on the Kurdish front, and the divisions within the Kurdish population which we tried to elucidate numerous times before are now becoming more clear-cut and more pronounced as well.
- The CBRT moved to "wait and see mode" for a while as that is the only possible reading of last week's MPC decision to stay put with respect to both the policy rate and RRRs.
- Capacity utilization figures hardly depict an "overheating" environment. If anything, the figures may very well be pointing to a slowdown in economic activity.
- For a change, the last weekly data release contains some "news". Though only one data point itself, it may be suggestive of a much less aggressive credit expansion in the upcoming period.

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1.1 General Outlook

Election is only 2 weeks away and in addition to the polls by "usual suspects", the well-known pollster companies most of which suffer a significant credibility problem, we are being informed about some "confidential" polls conducted by interested parties, namely Russia and the United States. These polls, the rumor goes, indicate the CHP as the number one party with the AKP losing ground in a mind boggling fashion. We have believed for quite some time that when it comes to the mainstream media in Turkey, multiplying headline info by, say, minus 0.8 (a totally ad hoc number which is representative in the sense that it is close to unity) will take you closer to reality. In simpler words, take almost the exact opposite of the assessment in the mainstream media, particularly in periods like pre-election times, and you are in the vicinity of "the truth". When it comes to bogus polls of the type mentioned above conducted by "dark forces", the correction factor is a straight minus 1.0, we believe.

It is difficult to make any predictions at this juncture as some soul searching will take place among voters of two parties in particular, the main opposition CHP and the nationalist MHP which has been hit with releases of indecent content videos pertaining to their top level executives. The CHP is playing the "come whoever you are" game with an attitude that aims at embracing voters from all wings of the political sphere in order to maximize its votes in the upcoming election. That in turn is bothering a portion of the traditional CHP base that is hardcore secular, allergic to all sorts of autonomy for any group or ethnicity (read that as the Kurdish ethnicity), and aggravated by recruitment of some hardline rightist figures of the past into CHP ranks. Yet the first and the last of these three factors would easily be forgotten or done away with when it comes to voting as the MHP scores not very high in the eye of the traditional CHP voter when these two traits are considered. Yet the Kurdish issue is so overwhelming in the genetic code of the quintessential CHP voter possessed by the concept of "unitary state" that CHP leader Kilicdaroglu's mostly strategic and pragmatic overtures to the Kurdish region created significant discontent among this group. The MHP tries to steal away as much of this constituency as possible and it might work to some extent. The video releases are said to have inflicted no damage on the MHP vote, but we believe that is a fairly remote possibility. We are not talking about a liberal party whose constituency would be much more disturbed by the violation of privacy than by content entailing indecent exposures. This is a nationalist party that prides itself on its loyalty and strict adherence to the values of Turkish and Muslim traditions. While it is true that the victim mode could be cashed into support under certain circumstances, this does not look like one of those cases for the MHP and its high command.

A very interesting development is taking place on the Kurdish front, and the divisions within the Kurdish population which we tried to elucidate numerous times before are now becoming more clear-cut and more pronounced as well. For the first time, a pro-PKK news media took an anti-Ocalan stance and openly accused the jailed PKK leader of getting engaged in meaningless negotiations with the Turkish State and thus becoming virtually a tool for the AKP's campaign on the Kurdish problem/solution. This, we believe, is a breakthrough in the sense that hitherto concealed antagonisms are now being brought to day light and Kurdish people will more openly be invited to choose sides. How is Kurdish Party BDP positioned in this quagmire? They dare not dirt the name of Apo, the jailed leader of the movement, but their animosity towards the AKP seems to suggest that they are not totally disenchanted with the anti-Ocalan movement either. Our hunch is that Ocalan is being subtly discredited by certain sects within the PKK and within the broader Kurdish movement, but this has nothing to do with the previous disenchantment that we had referred to before, the one that we had attributed to anti-PKK Kurdish citizens. Quite to the contrary, this recent disenchantment stems from circles that are more pro-PKK than Ocalan himself who had recently criticized some sects of the PKK for "playing the guerilla game" in a tone that was suggestive of addressing a kindergarten crowd. BDP command chain also had its fair share of reprimand and lecture and was presumably aggravated by what they heard from the jailed leader. This will lead to no positive repercussions for the AKP in the short-run in terms of votes, but it would not be a surprise to see in the foreseeable future an Ocalan that is much more amicable towards the AKP, and this despite his current rhetoric regarding the AKP that is totally discrediting. This was not possible until now as the movement "looked" quite monistic though it had started disintegrating from within, a process which could not be made public as it would hurt the movement. The divisions must have become keen enough not to be concealable anymore and thus we have this groundbreaking disclosure in the Kurdish media. Once again, no short term gains for the AKP, but it should be able to render the upcoming environment more conducive to fruitful negotiations with the peace-seeking sects of the Kurdish movement.

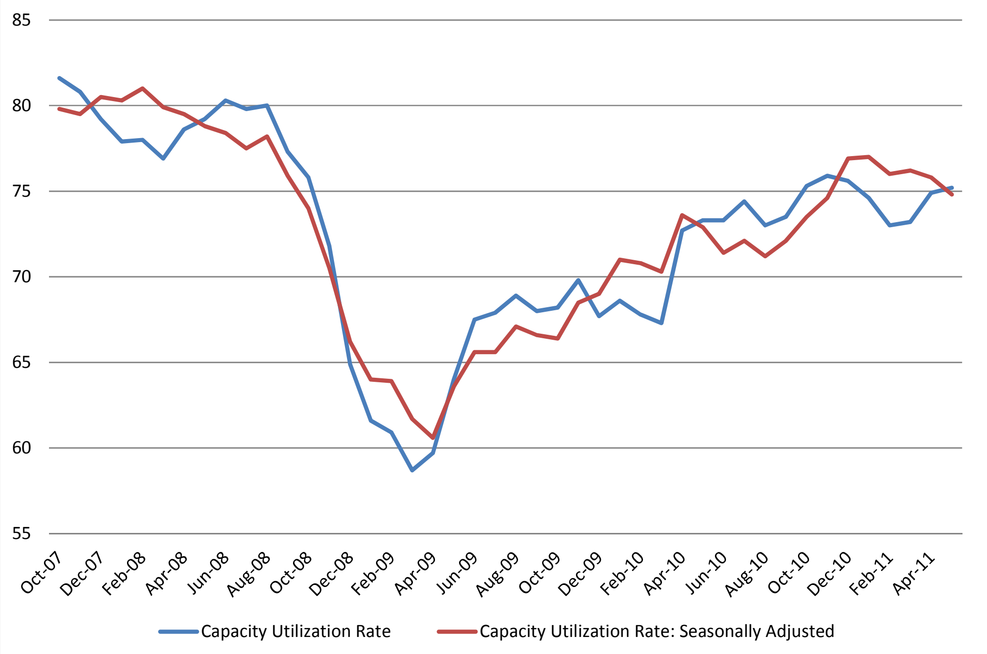
The flirtation taking place between the main opposition CHP and the hardline BDP is quite interesting but not surprising at all. The grand coalition that we had referred to in the past, the one against the AKP that included every political entity under the Turkish sun with the possible exception of Has Party, a party with an Islamic heritage and a vote potential around 1-2%, had to be a bit more subtle and concealed, but coalescing parties seem to have decided to lift the veil and show the true face as more transparency must be deemed more promising for some reason. That may or may not be so, and we will only know once we have the election results on June 13.

1.2 Macro Data

The CBRT moved to "wait and see mode" for a while as that is the only possible reading of last week's MPC decision to stay put with respect to both the policy rate and RRRs. The CBRT's new Governor Basci had recently informed market participants in his first meeting in Istanbul that further tightening should be expected in the second half of the year. We, like most others, received that as further hikes in RRRs but no policy rate action until genuine demand side inflation pressure kicked into the picture (others meaning the few that very much like us doubted overheating). That still may be the case, but some waiting will take place in this gestation period pertaining to the sum of previous actions taken on policy front. This comes at a time when markets are talking about a CBRT that has fallen behind the curve and thus will have to pay a higher than needed price in the future. We still do not buy this call. It is true that inflation will be going up, and so will core inflation. It is true that there has been high growth in the economy last year which somewhat extended into 1Q2011. Yet none of this is sufficient to render an environment of "overheating", and we believe *that* particular state of the world for the Turkish economy is about a year away from now. That is what our research suggests, and other houses have spelled different time horizons using models different from ours. We see serious methodological deficiencies in all those models that depict overheating at the moment or in the immediate future, and tried to elucidate in our research what their problems were, and hence the source of their wrong inferences and their misguided policy propositions. We naturally deserve and expect reciprocity, i.e. a criticism of our research methodology and hence a critique of our inferences and policy propositions. None has come so far. That may be because advocates of the opposite view could not come up with any discernible criticism of our methodologies, which would be bliss for us had it actually been the case. Or it could simply be because we do not reach a wide enough audience and/or that to the extent we do, we fail to generate enough respect to be dealt with the kind of esteem a critical look necessitates. It presumably is the latter of these two possibilities.

Capacity utilization for May indicates a CUR that still hovers around 75%, but seasonally adjusted CUR has indeed come down discernibly from 77% levels at the end of last year to 74.8% levels in May. These figures are hardly supportive of an overheating argument. If anything, they may very well be suggesting that domestic demand is also easing somewhat and that the supply side is merely reacting to that moderation on the demand side.

Capacity Utilization Rate (%)

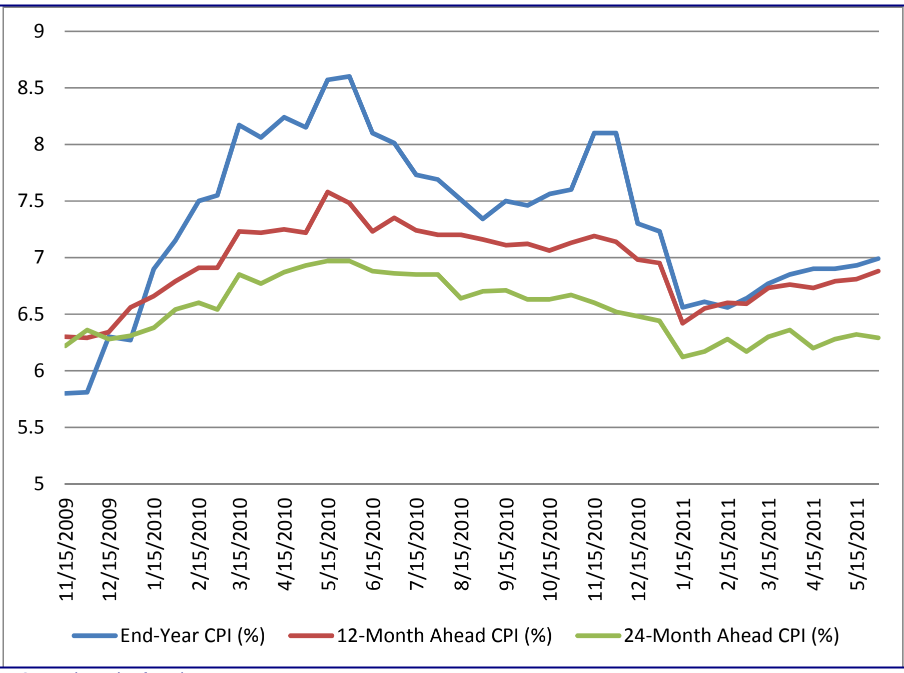


Source: Turkstat, TDM

We had talked about a wage index corrected for productivity and CPI in one of our earlier reports and had shown that the index had indeed come down somewhat, pointing to no visible wage inflation pressure in the labor market. April PMI had come down to 52.7 from 56.1 a month ago, almost all sub-indices had a poor showing in the same PMI, and we did not extract any sign of overheating in those figures either.

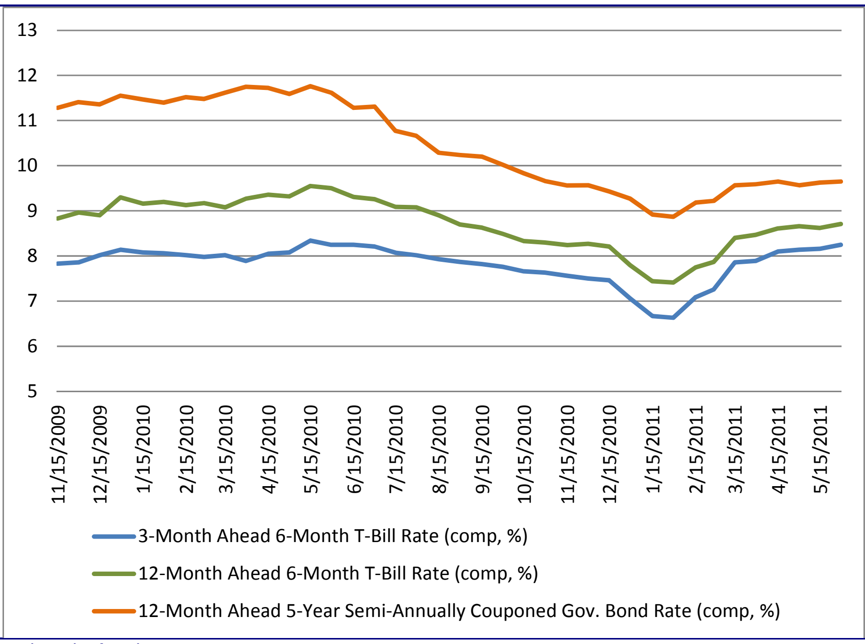
The second expectations survey of the month conducted by the CBRT entailed hardly any news as inflation expectations edged up slightly for year-end and for the 12-month horizon, but was slightly lower for the longer 24-month horizon. These we mention not because they depict any kind of behavioral change on the part of expectation forming agents; we do so simply to show that these expectations are indeed quite difficult to interpret. Why is the longest term expectation lower while the shorter ones are higher when the market mostly believes that the CBRT is falling behind the curve? Difficult to answer, at least for us.

Inflation Expectations



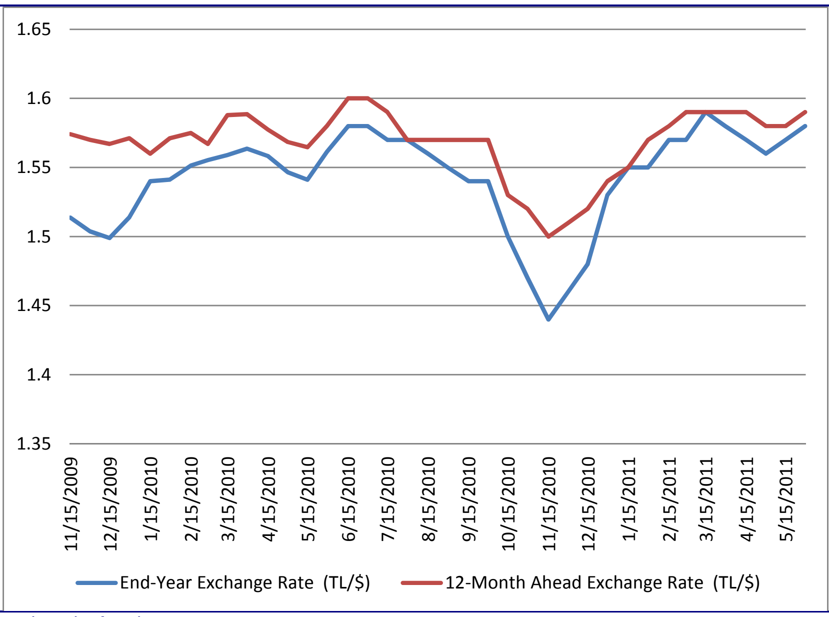
Source: Expectations Survey, Central Bank of Turkey

Interest Rate Expectations



Source: Expectations Survey, Central Bank of Turkey

Exchange Rate Expectations

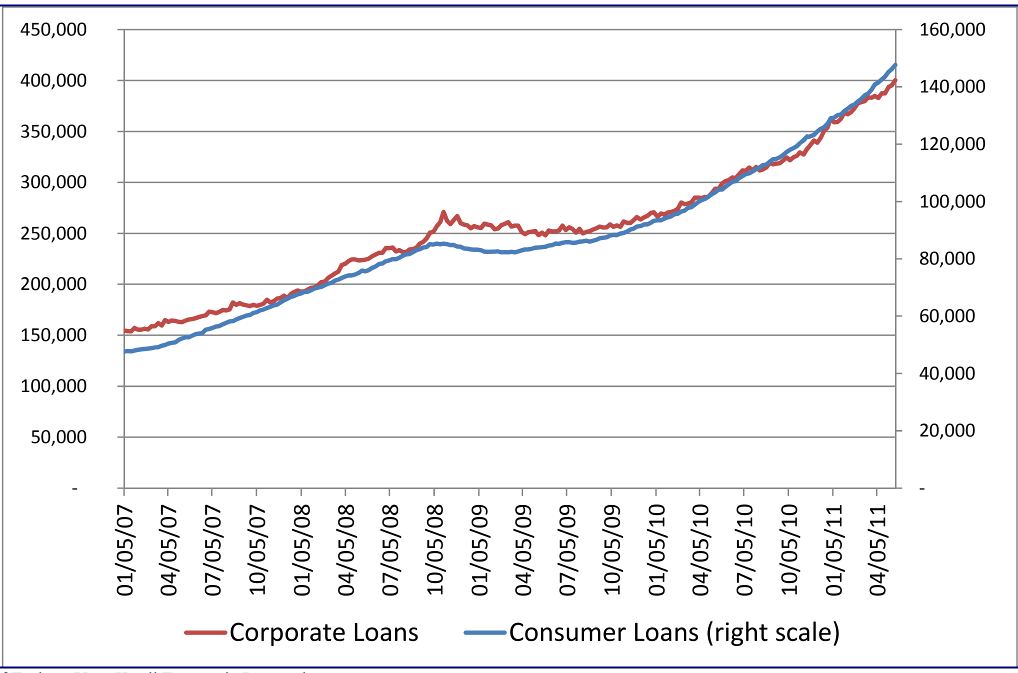


Source: Expectations Survey, Central Bank of Turkey

1.3 Weekly Data (all weekly data terminate on May 13, 2010 while consumer credits are one extra week updated)

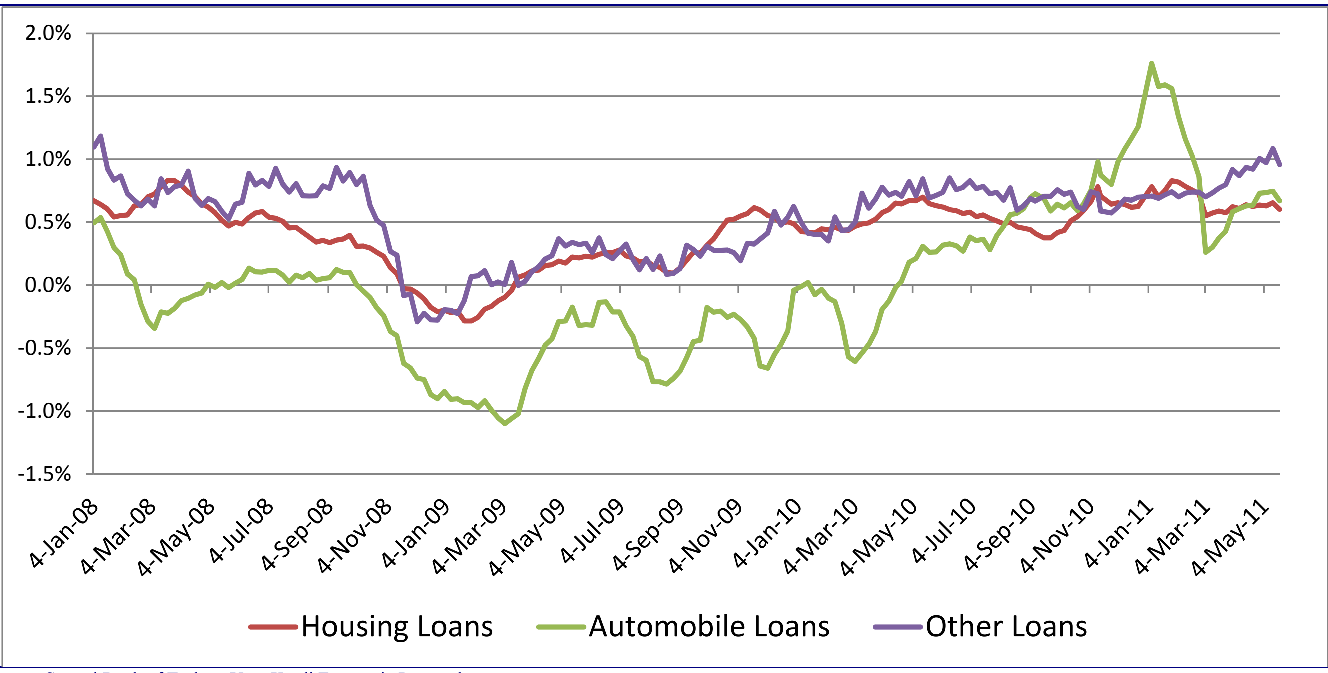
For a change, the last weekly data release contains some "news". Consumer loans displayed a weekly increase of TL 366 million, the third lowest since September 2010. A single data point once again, thus with minimal statistical credibility but our hunch supported by anecdotal evidence is that we will be seeing more of these modest increases in the upcoming months. WoW charts display sharp reductions while YoY charts started to display the loss of momentum in a quite visible manner. We have two more weekly data releases by the election on June 12, and if similar data pop in those two releases, a single party government combined with benign data on credit front could actually help eliminate the "behind the curve" CBRT perception and lead to a minor rally in markets.

Consumer/Commercial Credits - Levels



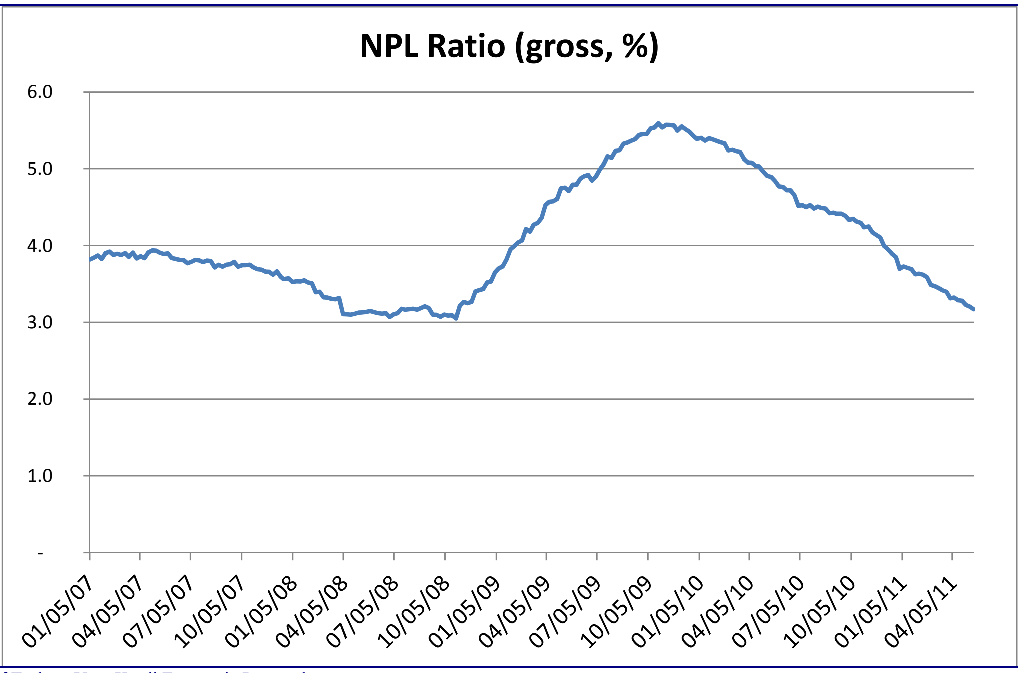
Source: Central Bank of Turkey, Yapı Kredi Economic Research

Consumer Credit Volume (*)



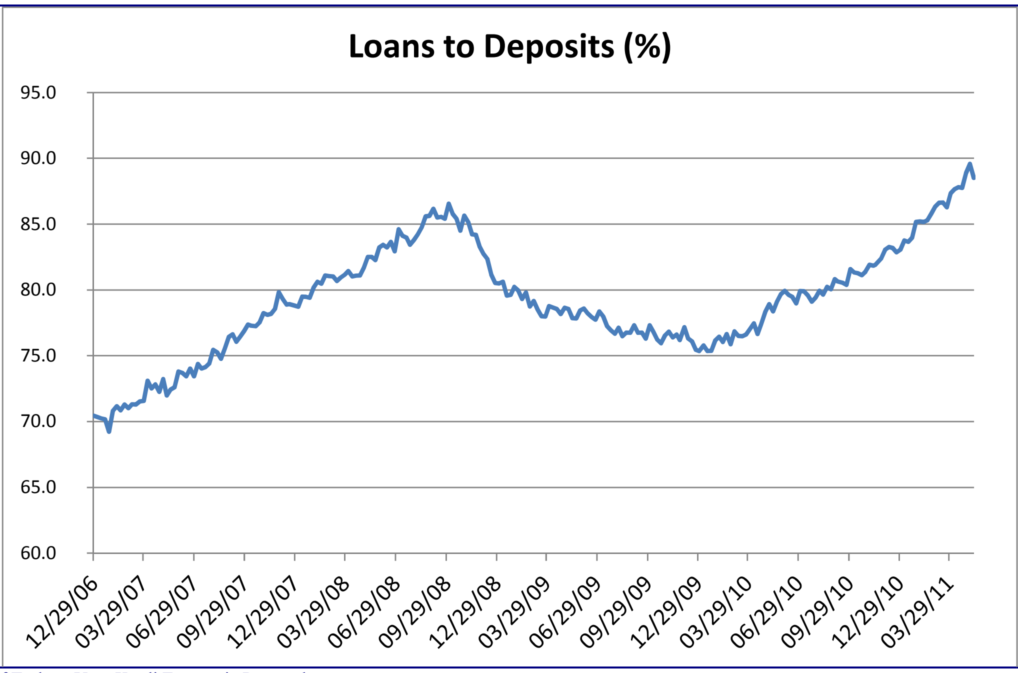
Source: Central Bank of Turkey, Yapı Kredi Economic Research
(*)Weekly % change of 8W average

NPL



Source: Central Bank of Turkey, Yapı Kredi Economic Research

Credit/Deposits Ratio



Source: Central Bank of Turkey, Yapı Kredi Economic Research

Markets

by Murat Berk / Economist and Investment Strategist

Minsky's Vision

"In Minsky's vision, business cycle fluctuations of employment and income are mere surface manifestations of the deeper fluctuation in financial conditions along the scale from robust to fragile and back again. Like Schumpeter, Minsky understood fluctuation as the way in which the capitalist system grows, but for Minsky the underlying process was not absorption of technological change but rather the expansion and validation of financial commitments. What worried Minsky was the prospect that, left to its own devices, the financial system would operate to amplify rather than to absorb the naturally cyclical process of growth, as each commitment provides the support for others on the way up, and as default on some commitments undermines other commitments on the way down."
Dr. Perry Mehrling, Columbia University's Barnard College, "The Vision of Hyman P. Minsky." The Journal of Economic Behavior & Organization Vol. 39 (1999).

Part of our broad thesis has long been that the market was too much fixated on overheating while the growth dampening effects were overlooked. Now, it seems that we have come to the point where these effects have become more visible, market opinion has turned more pessimistic and markets look short-term oversold now.

In an important paper on modern monetary policy theory (Orphanides, Athanasios, and John C. Williams (2002). "Imperfect Knowledge, Inflation Expectations, and Monetary Policy," The Federal Reserve Board, Washington D.C) the authors outlined what is perhaps one of the most critical rationale for modern central bank "transparency."

In their paper, Orphanides and Williams argue that modern central banks operate in a world of adaptive expectations and imperfect knowledge, instead of rational expectations and perfect knowledge. Private agents do not understand the full structure and complexity of the economy, and do not fully understand the parameters of their central bank's reaction function in real-time. Private agents, therefore, must infer the knowledge they need to make decisions, from observations and extrapolations of recent history – a process known as "finite memory learning." The authors suggest that in a world of "finite memory learning," private agents are prone to display an imperfect and undesirable stickiness in their expectations, which over time lend a stochastic dimension to central bank reaction functions. Sounds familiar?

On financial stability, history has taught us that unconstrained credit systems are inherently unstable - and the longer excesses and imbalances are accommodated the more serious the consequences from the impairment of underlying financial and economic structures. This may be in contrast to the conventional view of "perfect/efficient" markets, which still disregard asset price inflation until they affect either price or financial stability.

Markets are inherently susceptible to recurring bouts of instability and illiquidity. Financial innovation and credit expansion can create credit cycles, replete with self-reinforcing liquidity conditions both upwards and downwards. Also, credit excesses can mask a maladjusted economy and especially mature/late-cycle excesses are the most perilous because of their effects on the underlying structure of the financial system and economy.

Usually but not always, policymakers are caught confused and/or accommodating as they are seductive as there is generally no constituency to stand up and demand the policymakers to rein in asset price inflation, in our view.

The risk for economies rise when financial developments take over from economic development and create a highly credit-dependent system. These cycles may also lead economies to become distorted by inflations in incomes, corporate earnings, government receipts, spending and private investments.

There are a couple of important concepts that are fundamental to this analytical framework. One is the moneyness/availability of debt. As long as debt enjoys reasonable demand it can be created in abundance - in an extreme case fueling a runaway credit cycle. Contemporary "money", is really no longer about the government printing money. Instead, "money" is today also the domain of private sector credit.

Think of it this way, a credit cycle financed by scarce/high real interest rates is unlikely to progress too far – self correcting forces will probably restrain and put limitations in demand and supply. On the other hand, a boom fueled by very low real rates has the very real potential to get out of hand.

Another important point is that market place liquidity is not a pool of always available money but rather a function of Keynes' "animal spirits". Put differently, in today's globally integrated banking and capital markets, market place liquidity is about borrowers' and lenders' collective appetite for risk not a function of the printing presses' speed.

And this gets to the heart of the issue. Over the life of the boom a disconnect between the market's perception of "moneyness/liquidity" and the "reality" may develop. If and when the market's perception of "moneyness/liquidity" changes - this could turn out to be a major development. Please remember that Greece had two year bond yields of around 2% in 2009 vs. today's around 24%.

As a tangent, here is Keynes' important passage from his seminal Chapter 12 (which can be considered the first behavioral finance text, in my view) on asset prices conventional wisdom, liquidity and credit availability:

"A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield; since there will be no strong roots of conviction to hold it steady. In abnormal times in particular, when the hypothesis of an indefinite continuance of the existing state of affairs is less plausible than usual even though there are no express grounds to anticipate a definite change, the market will be subject to waves of optimistic and pessimistic sentiment, which are unreasoning and yet in a sense legitimate where no solid basis exists for a reasonable calculation.

So far we have had chiefly in mind the state of confidence of the speculator or speculative investor himself and may have seemed to be tacitly assuming that, if he himself is satisfied with the prospects, he has unlimited command over money at the market rate of interest. This is, of course, not the case. Thus we must also take account of the other facet of the state of confidence, namely, the confidence of the lending institutions towards those who seek to borrow from them, sometimes described as the state of credit. A collapse in the price of equities, which has had disastrous reactions on the marginal efficiency of capital, may have been due to the weakening either of speculative confidence or of the state of credit. But whereas the weakening of either is enough to cause a collapse, recovery requires the revival of both. For whilst the weakening of credit is sufficient to bring about a collapse, its strengthening, though a necessary condition of recovery, is not a sufficient condition."

Just as Minsky and Keynes warned decades ago, when the conventional basis of valuation for many assets (i.e. Greek bond) was undermined, the asset class imploded "violently." And the implosion was not, as some mavens predicted, contained. Rather it has the potential to become contagious, with all "risk assets" re-pricing to higher risk premiums, perhaps in violent fashion, and then on Main Street, where growth is losing some steam, taking a new leg down.

Thus, a major tightening in credit conditions may ushered in a decline of credit creation, which could will lead to escalating problems among borrowers, which in turn could lead to credit losses, home pricing pressures and marketplace illiquidity.

An unrecognized dilemma we may face in the future is that to sustain financial and price stability we need positive but lower credit growth. And to sustain economic growth will require financial and price stability and a continuous credit creation mechanism with a strong risk intermediation system.

And here's the paradox, the success at achieving financial and price stability carries its own risks. All policy, including economic and monetary policy–to the extent that it is successful over a prolonged period, will reduce volatility, perceived credit and interest rate term premiums/risks, creating the conditions for future system fragility unless policymakers rise to the challenge.

As the great Hyman Minsky opined "stability is destabilizing."

In line with our expectations, markets have been selling off. Market opinion seems to have turned more pessimistic and markets look short-term oversold now. Thus, I suggest taking profits on short risk assets positions and my personal shorter term market view changes from bearish (short) to neutral (net flat). That said, I'd continue to ride profits on some of our "thesis positions" such as long USD, stock put warrants and short silver.