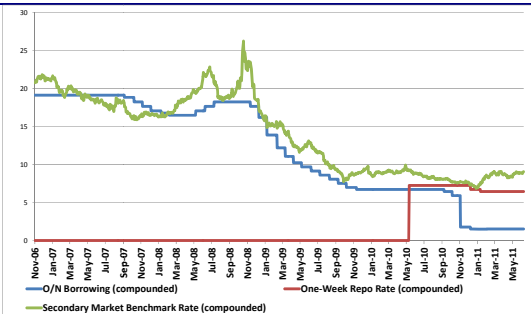


# Turkey Weekly Macro Comment

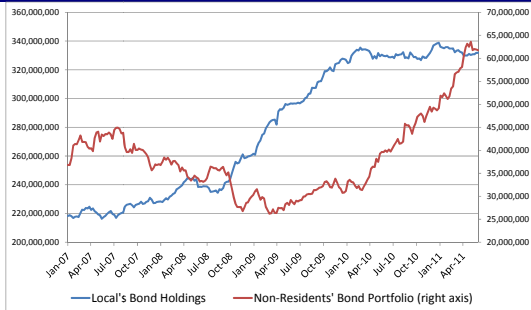
20 June 2011

## 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

## On Consensus and Nonsense Interpretations of Election Results

- We argue that most post-election headlines were taken as granted despite their lack of correspondence to a meaningful state of the world.
- The most important part of PM Erdogan's balcony speech, we believe, was the part that pertained to his foreign policy strategy designed to render Turkey a much more active player in the region and globally as well.
- While local coverage of the election was very much to our discontent, coverage in foreign media was not much better we have to say.
- Budget performance as depicted by May data is still strong thanks to revenue generation.
- Unemployment took another dip and came down to single digit levels in seasonally adjusted terms once again in March, coincidentally to March 2007 levels to be precise at 9.9%.
- The BRSA finally made the long awaited move (by the CBRT as well, we believe) and participated in the show, increasing the provisioning on general consumer need loans to 4% (a four-fold increase rate-wise). More to follow, we believe.

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## 1.1 General Outlook

It has been exactly one week after the historical election the results of which are interpreted in the media as a very strong mandate to the AKP for a new era. There is no denying this as a fairly accurate snapshot of the results, but the devil is usually hidden in the details. Let us take a look at the math of all this in the first place. Here is a comparative performance analysis for the three most important political entities of the next four years; the governing party AKP, the main opposition CHP, and the much heralded new star of the political spectrum, the Kurdish party BDP.

	Share			Vote Count			Seats		
	2007	2011	Difference	2007	2011	Difference	2007	2011	Difference
AKP	46.58%	49.90%	3.32%	16,340,534	21,466,446	5,125,912	340	326	-14
CHP	20.88%	25.91%	5.03%	7,300,234	11,147,692	3,847,458	112	135	23
BDP	5.24%	6.65%	1.41%	1,822,253	2,826,031	1,003,778	27	53	26

Notwithstanding the base effect which is undoubtedly very important, it is still striking to observe that while the CHP and the BDP increased their votes by 52.3% and 41.2%, respectively, which corresponded to absolute and percentage increases in the number of seats they gained in the Parliament, the AKP turned out to be a loser seat-wise when its superlative performance with respect to the number and the percentage of votes astonished most analysts and election-watchers. The Kurdish party BDP must be head over heels in love with the 10% threshold which ex-post seems to have helped them immensely. It is once again very important to remind ourselves of the difference between the ex-ante and the ex-post which is so rampantly ignored by the media and the public opinion makers here. For some reason, the distinction is not internalized very much like another concept which I emphasize every now and then for different reasons; trade-off. As some of our readers may recall, we do not have a word for trade-off in Turkish though we know what the concept corresponds to. Despite the fact that we have some long phrases (some quite funny) that correspond to the concept itself, the concept has not been operative in rhetoric formation which led to the absence of a word that matched the concept. The ex-ante/ex-post assessment difference has a quite similar fate in the public state of mind for a number of reasons. First and foremost, the education system is not very keen on developing cognitive skills, a fact we analyzed and played around with in an OCM we published some time ago<sup>1</sup>. In the absence of such skill development, ex-ante randomness is hardly accounted for and the ex-post state of the world is assumed to be the outcomes of a deterministic process. Secondly, once formal education is over, the main source of information, the media that is, happens to be a shrewd after-the-fact interpreter with hardly any emphasis on ex-ante possible states of the world and their ex-post implications for different agents. Instead, the media sometimes turns out to be totally ignorant or adamant to its surroundings, the thorough analysis of which ought to be its main task. Other times, the more tactful media displays commendable skills in coming up with arguments that recklessly

<sup>1</sup> "La Mala Educacion: In Search of a Gutsy Policy Maker",

slide between the general and the particular, using facts sparingly to serve a cause when they exist and using speculative sophistry when they do not. It is not infrequent that we have witnessed fascinating narrative bordering on outer limits of creativity constructed by media out of evidence that is desperately circumstantial at best. The AKP Government has been the prime target of such biased “sentiment manufacturing” by the media within the last decade, but the practice has been quite rampant and is not limited to that which was directed against the AKP only.

Speaking of the media and our general discontent with its performance in serving as a source of information for the public at large, let us pick two common post-election headlines that hardly attracted any attention despite their lack of correspondence to a meaningful state of the world. The first one was: “The Voter Chose Stability”. Here is the first and the most important question that pops up immediately: Over What? Before indulging in that interesting question (to us at least), it is worth noting that the word “stability” is inherently neutral and colorless. You can have stability in a bad equilibrium or stability in a good equilibrium. Barcelona football team displays great stability year after year as a candidate for all trophies available in the world of soccer. Yet so do some other teams in La Liga that try to avoid relegation every year. Stability seems to exist at both ends of the status spectrum. Notwithstanding this inherent neutrality in the concept, the connotation happens to be positive most of the time when one talks about stability. Let us come back to our very common headline and its interpretation now. The headline, as it is, is both a truism and a meaningless statement at the same time depending on the object in the statement. The AKP voter obviously voted for stability, but that is marginally less than half of the total voter population with 49.91% of the votes. The interesting question is: What did the rest of the constituency (mathematically the majority if you are a numbers guy) vote for? Did they not see some sort of stability that they assessed as desirable or did they not vote for it nevertheless for one reason or another? Or did they indeed appreciate the stability observed until the election time and thought that the very same stability could be sustained under a different government that did not include the AKP? Our hunch is that this last option is a mental exercise constructed by us just for the sake of mental exercise and for inference purposes through elimination. In the non-AKP constituency of the public, an appreciation for the AKP’s performance in the last decade is not a widely shared sentiment. There are those who believe the AKP is about to precipitate the country into a dismal state of authoritarian/Islamist environment as a result of its Ottoman aspirations which will be at the expense of the Westward direction the Republic opted for roughly nine decades ago (the informed reader would know that the choice indeed goes way back to 1830’s, but that is the subject matter of a different piece by itself). That portion of the constituency will only be cured by time and by compiling of data to the contrary in the future and cannot be a target base for the AKP in the foreseeable future. Then there is a second portion of the constituency which is very much and extremely favorably affected by the economic agenda that the AKP has pursued in the past decade, and they would rather have the AKP stay in power but they vote for the opposition party CHP nevertheless.

Their pretext happens to be their motivation to “balance” or “equilibrate” the political setting which would be precipitated into a dismal state of disequilibrium if the AKP has the critical 330 mass in the Parliament, which they did indeed have for the last four years. This “presumed capacity to equilibrate” is extremely enigmatic to us if nothing else. More importantly, this voter type suffering from split personality syndrome is peculiar to this country only and cannot be observed in any other country, we believe. The fact that most of the financial sector participants’ behavior could be included under this category is quite telling as the sector is presumably the most “educated” strata of the society. Unlike the previous portion of the constituency we mentioned above which would be deemed incurable or impossible to recruit by any AKP strategist, this second segment does indeed entail some potential AKP supporters.

The very presence of this segment suffering from split personality syndrome actually brings us to the second cliché which puzzles us as much as the first one we tried to tear apart at the outset since it is equally void of any meaningful content: “The Market Liked the Results”. Who is this market, the financial market that is? Well, logically speaking, the market comprises all the individuals employed in the sector in some capacity one could say. Mathematically speaking, a market at least 50% of which had voted for the AKP would have naturally liked election results, but our ball park estimate would be that at most 10% of market participants may have voted for the AKP (and that is a fairly optimistic - or pessimistic, depending on your perspective - estimate by the way). So why does the market LIKE the results? Could it be because it feared a 55% showing by the AKP and was thus relieved by the outcome? That can’t be the case as hardly anyone anticipated a 50% showing on the non-AKP front. Some say because the critical 330-seat threshold was not exceeded, but that sounds more like a pretext and can in no way be conciliatory in the face of steadily increased support for the AKP in three consecutive elections, a rarity and even an exception not only in Turkish political history but in world political history as well. No rational argument can provide a cognitive explanation for the split personality behavior displayed by most market participants, and it happens to be reflected in “Market Liked the Results” headlines which do not match their disillusionment. This portion of the anti-AKP Turkish constituency is still the most “recruitable” segment from an AKP standpoint and it will be interesting to observe the evolution of this enigmatic and not truly amicable relationship going forward.

Is there anything the AKP can do to extend its voter base via additions from this segment of the society? New recruits from Turkish and Kurdish nationalists is always a possibility since the toning down of national sentiments is likely to benefit the AKP which already has a quite diversified voter base and power, we all know, is a natural attractor. The political maps we provide at the end of the Weekly are indeed very telling as to what we mean by power. What the AKP has to do going forward, in very vulgar terms, will be to respond to the remark “we do not like you” by something like the following: “fine, but let me tell you why your reasons

for not liking me do not make any sense, and once I am done explaining them, you may continue to dislike me as much as you can but hopefully not for the reasons you put forth in the first place.” “Well, we do not like you either” is not the optimal response, we believe. Not that the AKP does not have the *right* to respond in that fashion, but simply for the reason that it would not be *right* strategically speaking. The referendum in September must have hinted at the true vote potential of the AKP as it registered the Party as the only agent of normalization, which is indeed very unfortunate for the overall political system. It is a blessing and a curse for the AKP at the same time. The main opposition party CHP has woken up to this fact, or a portion of the Party we must say, and the emergence of Kilicdaroglu’s leadership is testimony to this awakening. This is very fortunate for the political system but Kilicdaroglu faces two severe challenges going forward. Firstly, he must overcome the opposition he faces from within his own Party; an opposition which is for the preservation of the status quo and against further political normalization. Secondly, provided he has overcome this internal conflict, he will have to demonstrate to the public at large and particularly to the less core portion of the AKP constituency that his Party can be at least as reformist, pro-EU, pro-liberalization, and pro-privatization as the AKP. Then again, “at least” may not suffice because those genuinely political floating vote holders will have to choose between a proven performer with a track record and one with promises only. On a more fundamental basis, the CHP will have to convince the voter base in Turkey that it does indeed have some contemplation about the future of the country and that its existence is not solely based on a negation of the AKP and its deeds. That policy based on antagonism, accusation, and negation simply has not worked and will not sell on this land.

PM Erdogan’s eagerly awaited traditional balcony speech was welcomed due to its compromising though by no means apologetic tone. He mentioned the word “compromise” a number of times, and he probably means it. Yet he also knows how difficult it might be to reach a compromise on the issue of constitutional change when memories pertaining to the amendments package in September are still very fresh. There is more reason to be hopeful though as the opposition cannot be as adamant or irresponsible as it was in the pre-referendum period after two successive defeats of historical scale. The AKP does have the upper hand now, and they will use it sparingly, tactfully, and in a way to never make them look like the irresponsible or the overambitious party in the process. The intention to move ahead with compromises is genuine, but PM Erdogan is a shrewd enough politician to know that victories enjoyed prior to any bargaining process give you significant leverage. Thus, we would beg to differ from some media experts who seem to assume that Erdogan would simply apologize and restart the entire bargaining process as many times as it needs to be done after failing to reach a compromise as if it was his own fault alone. He was a strong actor in the system and he got even stronger, which is a state of affairs that will further equip him with the comfort and the confidence that accompany strength. He will use that fortified stature of his in making his opponents bend as much as possible and it would be weird to think that he will emerge as the apologetic agent in the process at any point.

The most important part of PM Erdogan's balcony speech was the part that pertained to his foreign policy strategy designed to render Turkey a much more active player in the region and globally as well. PM Erdogan intentionally addressed an audience far beyond the borders of Turkey and assertively claimed that it was not only the people of Turkey emerging victorious from these elections but also the people in Baghdad, Damascus, Gaza, Amman, Cairo, Baku, Sarajevo, Skopje, etc., a wide range of capitals extending from one end of the Ottoman borders to the other. This is not a neo-Ottoman ambition as some choose to call it, but a genuine desire to be a legitimate power broker in the region, in PM's own words, "call(ing) for rights in our region, for justice, for the rule of law, for freedom and democracy". This is not a complete turnaround foreign policy-wise but a discernible fortification of an already adopted policy. Turkey, burdened by the natural load that strength and enhanced profile impose on her, has chosen to address the people of the region rather than leaders in the region. Outreaching to people of the region and staying in contact with leaders and administrations are not mutually exclusive; Turkey's unique position of having rapport with both indeed seemed to be an inherent advantage for a while. But when turbulence in the region reached gigantic proportions with popular uprisings intensifying, Turkey had to make a choice and she, or PM Erdogan at least, seems to have dumped the policy that prized stability in the region above anything else and opted for bonding with the people. It will be a challenging period and testing times for the AKP Government. The intention is both to present the "Turkish Summer" as a likely prospect to the bearers of the Arab Spring and to be more actively involved in the region by reaching out to the people rather than the establishments. The risks are there, visible and large, but the return/risk ratio could be beyond contemplation if the uprisings succeed in generating genuine change in the region.

Local coverage of the election was very much to our discontent as the reader should have perceived by now. Coverage in foreign media was not much better we have to say. What always struck us have been the naiveté and the orientalist approach flavored with a sauce of perfunctory intellectual righteousness foreign media so skillfully demonstrated in covering Turkey. We would like to end this section with a June 18 dated piece in Financial Times in the "Person in the news" section. The title of the piece dedicated to a post-election PM Erdogan analysis is "A self-confident new-age Sultan setting out his stall". Well, the Sultan label does not sound very complimentary during the Arab spring to say the least and hints at a pejorative tone in a subtle way. And here is the opening remark: "Turkey's newly re-elected premier has a remarkable record but he has his work cut out if he is to allay his critics' concerns, writes Delphine Strauss". What is the remarkable record about? When you glance over the piece, you see that it is mostly about the economy. So is this the same PM that asked for a "yes" vote in the historical referendum in September on the constitutional amendments which the EU publicly claimed would make Turkey "more EU compatible"? And are these the same critics who vehemently opposed the amendments and had to befriend the 42% that had voted "no" in the very same referendum? And here is the ending of the piece: "Mr.



Erdogan’s dominance of politics has brought stability and rising regional influence. His best legacy would be a constitution that allowed Turkey’s success to continue without a dominant leader. But to do that he will have to rein in his more domineering tendencies. Can he?”

The author ends up with a question which begs for a number of counter questions that would easily annul hers. Let us try instead to briefly display the inherent weaknesses in the approach adopted by the author. To attribute stability and rising influence to a leader’s dominance of politics is not only totally misguided and misleading, but is so reflective of orientalism at work here. Normalization of politics in this country within the last decade deserves no credit here, the relegation of the State below politics (its proper place in any democratic society) has no role to play in this stability and influence enhancement, and it is precisely this “domination of politics by a political figure” and not the political normalization that has been the source of aspiration for people of the region who are trying to get rid of “domination of politics by political figures or by State apparatchiks”!! Has the author by any chance taken a look at the existing constitution of the country and can she really have a rapport with that portion of the society that genuinely demands a change of the constitution? Could it be that it was that very same portion of the society that had voted “yes” in the referendum with the unfortunate exception of Kurds who were so involved in and preoccupied with inflicting some damage on the AKP that they forgot that their main agenda item was indeed a new constitution? The very last statement by the author is a very strong one and her doubt casted as a question is thus equally forceful. But without the proper analysis/perception of the underlying political structure here, both the statement and the question are hanging loosely in the air.

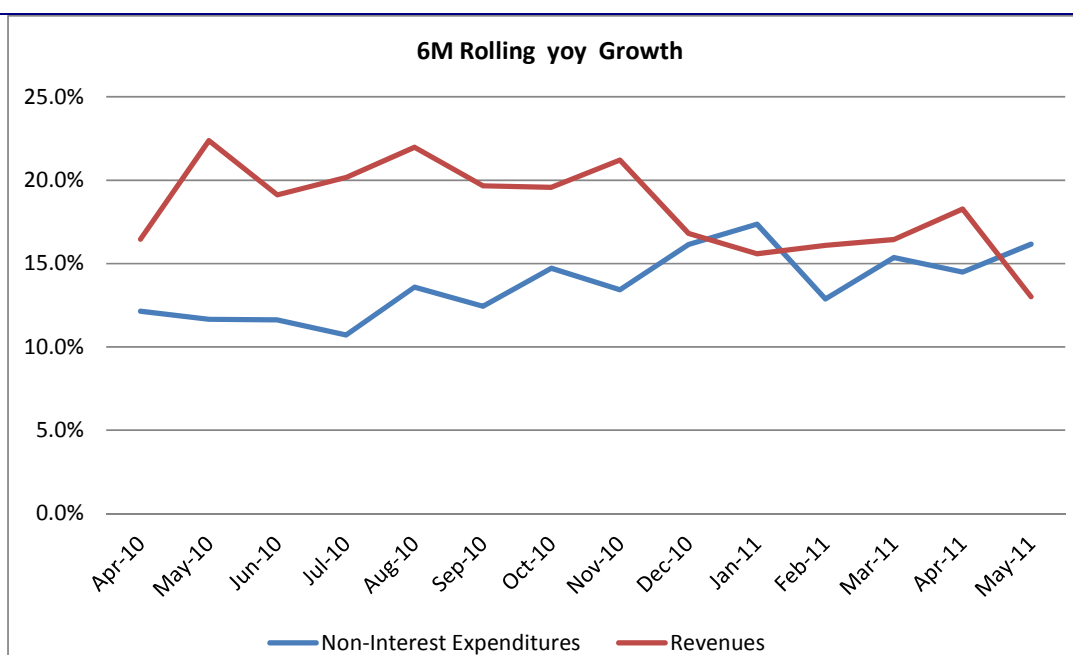
## 1.2 Macro Data

Budget performance as depicted by May data is still strong thanks to revenue generation. Rate of growth of non-interest expenditures in real terms in May at 11.8% was significantly higher than that of revenues at 1.8%. While that has no overriding importance as a single data point, 6 and 12-month rolling yoy growth schedules also indicate that caution is not to be neglected in the upcoming period.

Budget Balance (million TL)						
			year-to-date	year-to-date	12-month rolling	12-month rolling
	May-11	May-10	May-11	May-10	May-11	Apr-11
Central Government Revenues	27,133	24,866	119,385	102,617	270,797	268,530
Taxes	23,288	19,551	100,025	82,783	227,774	224,037
Non-Tax Revenues	3,845	5,316	19,360	19,834	43,023	44,493
Central Government Expenditures	24,298	19,054	119,618	112,600	300,646	295,402
Excluding Interest	20,234	16,890	98,744	88,384	255,692	252,348
Interest	4,064	2,165	20,874	24,216	44,954	43,054
Budget Balance	2,835	5,812	-233	-9,984	-29,849	-26,872

Selected Tax Revenues and Non-Interest Expenditures (million TL)						
			year-to-date	year-to-date	12-month rolling	12-month rolling
	May-11	May-10	May-11	May-10	May-11	Apr-11
Tax Revenues	23,288	19,551	100,025	82,783	227,774	224,037
o/w: Income Tax	4,009	3,137	18,997	16,151	43,237	42,365
Corporation Tax	5,034	4,759	11,876	9,805	22,996	22,721
Domestic VAT	2,219	2,239	11,879	10,213	27,991	28,012
Special Consumption Tax	5,095	4,739	23,624	20,683	60,226	59,870
Taxes on International Trade and Transactions	4,691	2,949	20,722	14,492	45,757	44,015
Non-Interest Expenditures	20,234	16,890	98,744	88,384	255,692	252,348
o/w: Personnel (inc. SSI premiums)	6,932	5,979	36,034	30,998	78,397	77,444
Good and Services Procurements	2,317	2,141	9,684	8,556	29,951	29,775
o/w: Health Expenses	526	442	2,007	2,005	5,753	5,669
Current Transfers	8,009	6,876	45,481	42,126	105,246	104,113
o/w: Social Security	3,166	3,557	23,844	23,178	57,047	57,438
Shares of Local Government	1,913	1,543	9,427	8,014	22,322	21,952
Capital Expenditures	2,619	1,620	6,182	4,539	34,286	33,287

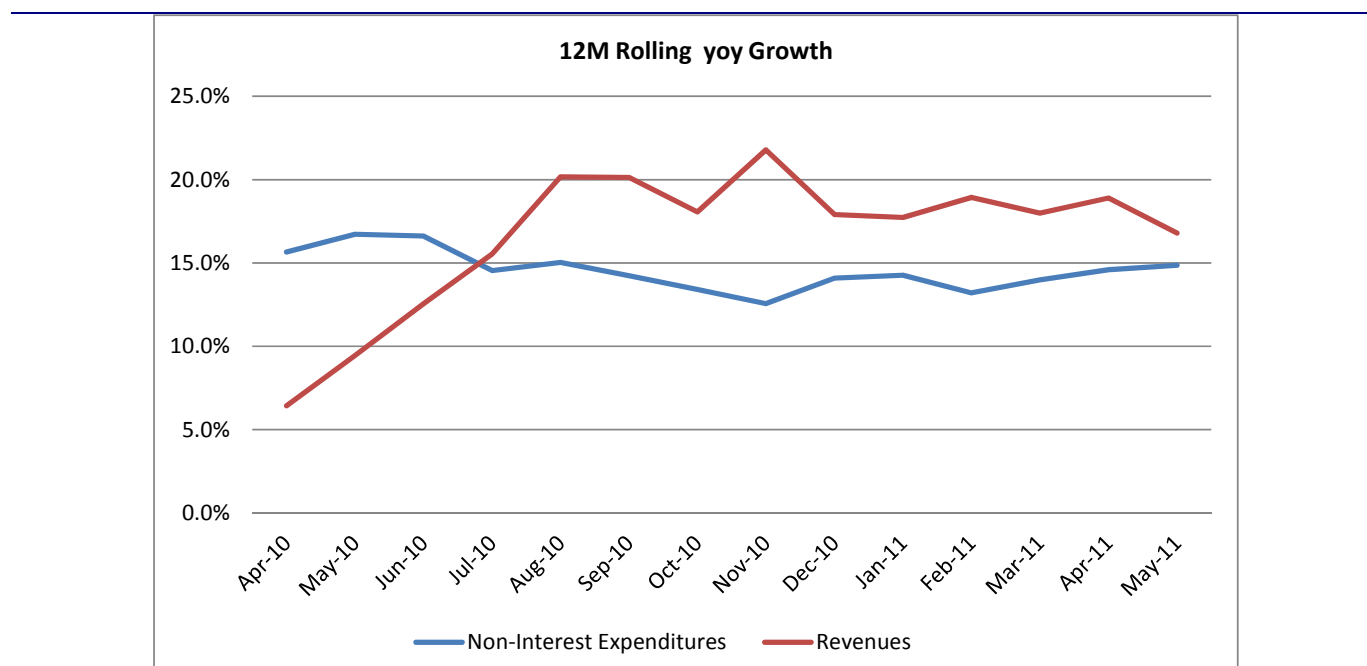
## Revenues Expenditures



Source: Central Bank of Turkey, YK Economic Research



## Revenues Expenditures

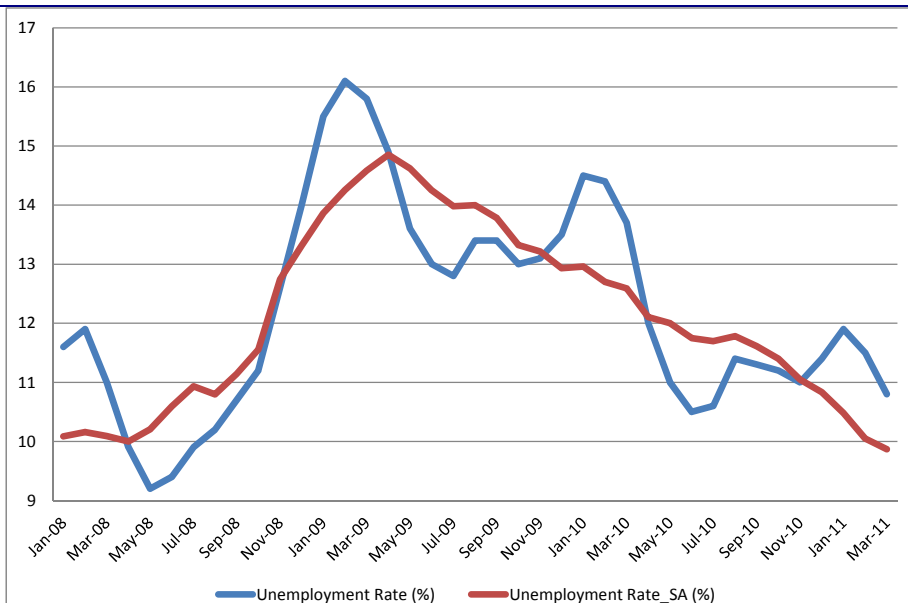


Source: Central Bank of Turkey, YK Economic Research

While fiscal discipline is and will remain to be of pivotal importance for an economy with a structural external deficit problem like Turkey, trying to find a solution to the CAD problem through the fiscal side is not a viable option in this specific case. We tried to elucidate this argument in our previous weekly. At the expense of repeating ourselves, here is a simple version of the rampant misinterpretation of the fiscal-current account link. Public sector balance + private sector savings gap = current account (trade account) deficit as an identity. The simplistic approach adopted by advocates of fiscal austerity is that when fiscal austerity leads to an improvement in the fiscal balance, current account will improve PROVIDED private sector saving gap remains intact. But does it? Does the data say it does from an empirical perspective? Although the identity would have to hold period after period, is there any endogeneity pertaining to private sector balance causing it to change as well when fiscal stance is changed? It is a rhetorical question that has assumed an enigmatic content here it seems. Add to this the totally private sector-led nature of the growth process in Turkey and advocating fiscal austerity as a panacea to the CAD problem becomes much less persuasive.

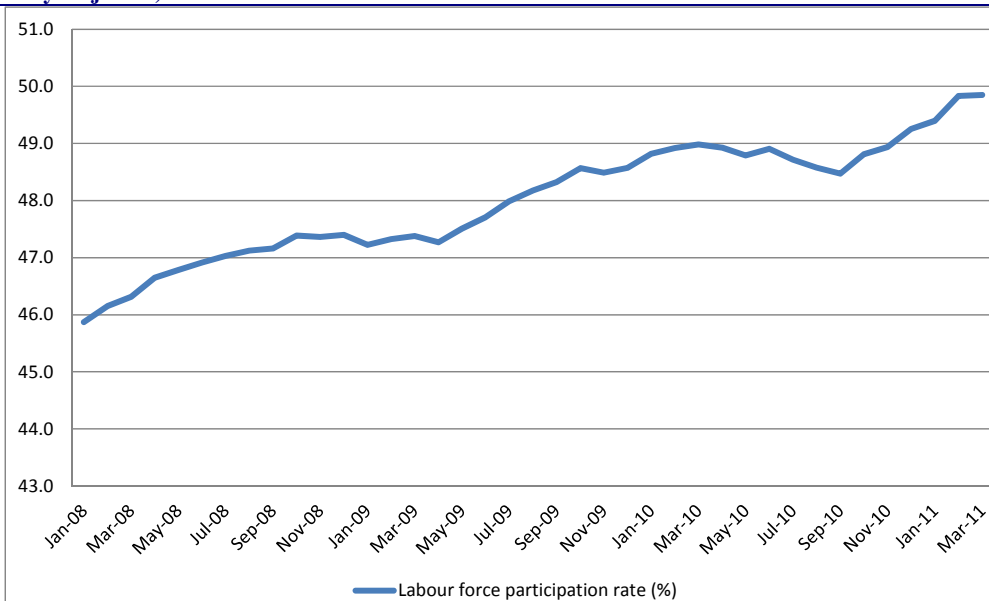
Unemployment took another dip and came down to single digit levels in seasonally adjusted terms once again in March, coincidentally to March 2007 levels to be precise at 9.9%. Roughly another 100,000 jobs were created in a month and the number of unemployed came down by 43,000 while labor force participation remained intact, making the reduction in unemployment a genuine albeit a small one. Still, the 2.7 percentage point yoy reduction in unemployment rate accompanied by a 0.8 percentage point increase in labor force participation is a significant correction for the labor market by all means.

### Unemployment (%)

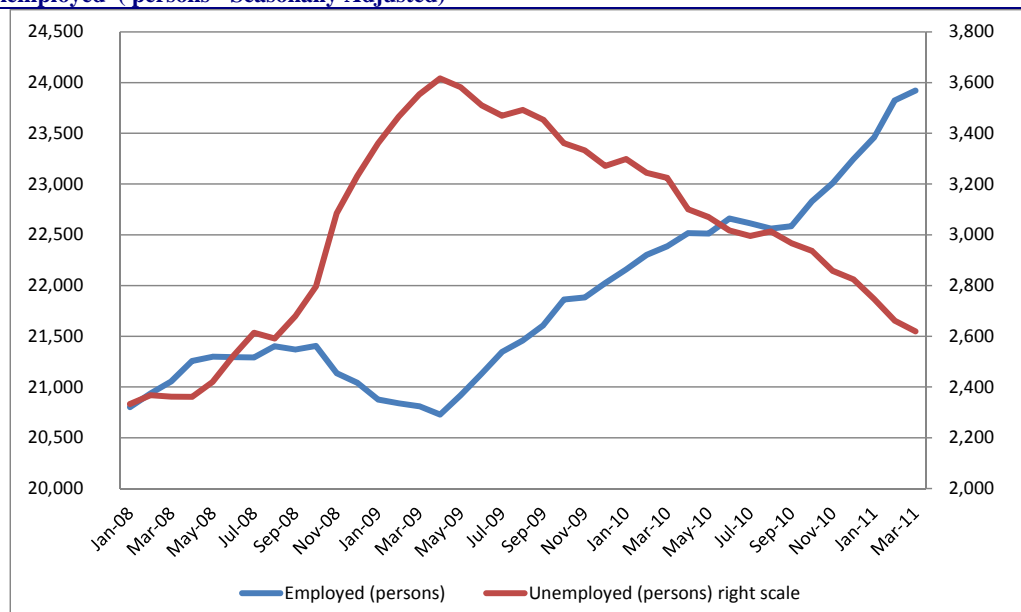


Source: TURKSTAT

### LFP Rate (Seasonally Adjusted)



Source: TURKSTAT

**Employed vs. Unemployed ( persons - Seasonally Adjusted)**

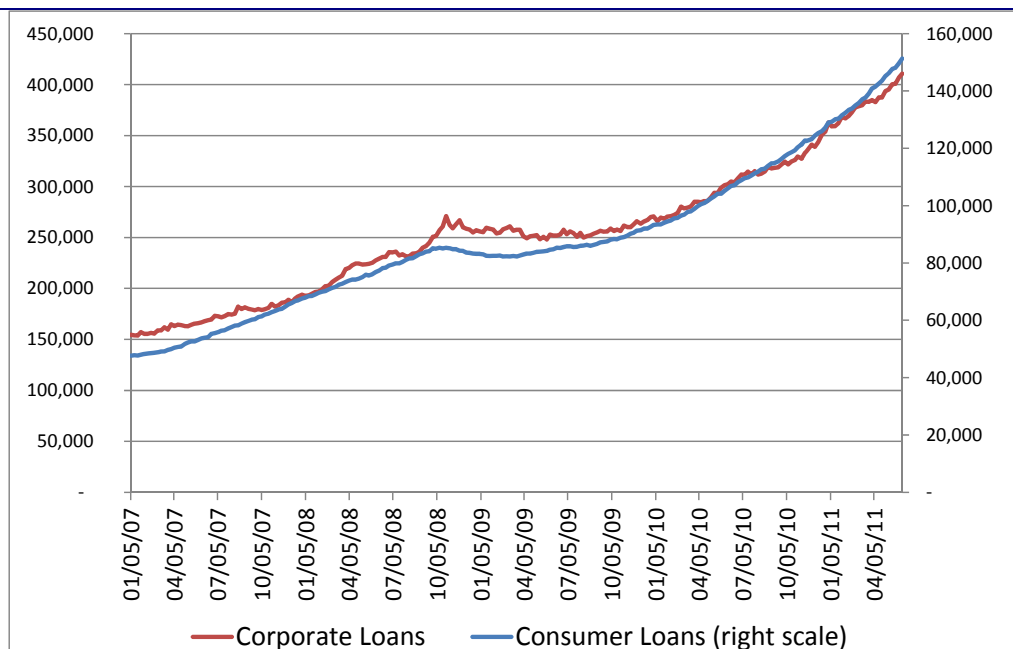
Source: TURKSTAT

**1.3 Weekly Data (all weekly data terminate on June 03, 2011 while consumer credits are one extra week updated)**

Some more frontloading has taken place it seems as expectation of harsh measures on credit usage following elections has been the story in town for a while. Consumer loans were up by a respectable TL 1.3 billion and other loans category led the way once again. Corporate loans were also up by a sizeable TL 4.2 billion and yoy change for the category stands at 34.8% as opposed to 43.6% for the consumer loans category.

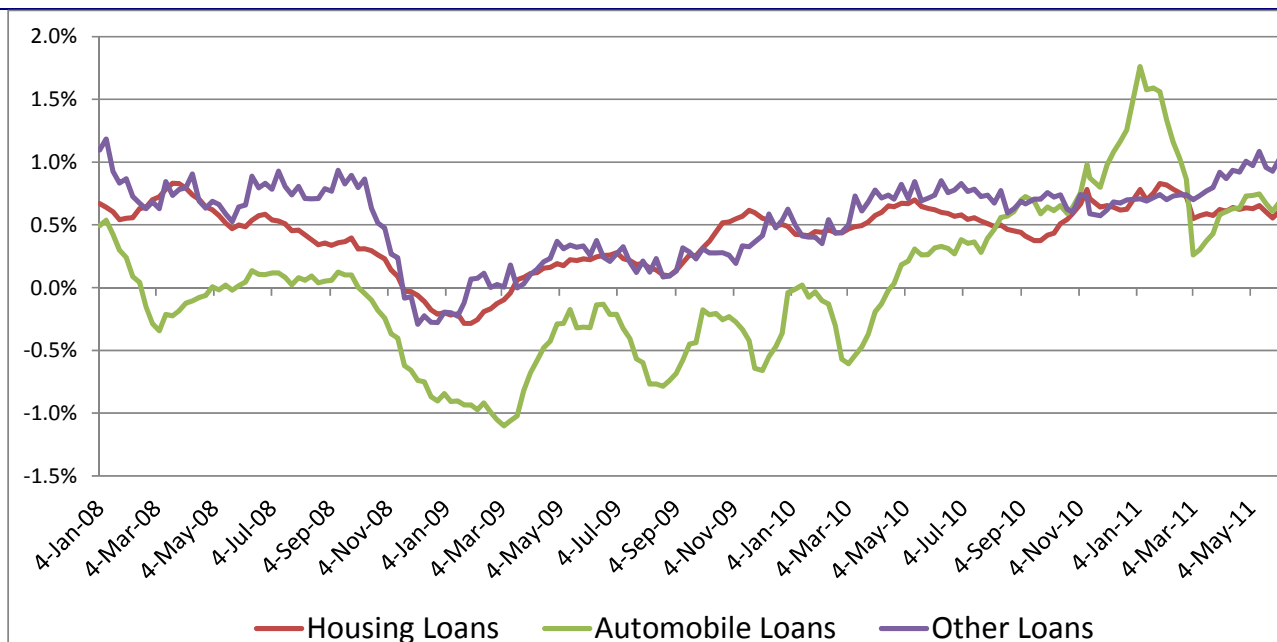
The BRSA finally made the long awaited move (by the CBRT as well, we believe) and participated in the show, increasing the provisioning on general consumer need loans to 4% (a four-fold increase rate-wise). NPL for the same category will also be subject to higher provisioning at 8%. As we had opined in our earlier weeklies, expect more taxation to come on the credit front, preferably designed in a way to move the incidence away from the bank and toward loan user. It is not an easy design problem, we admit, but efforts to that end should be encouraged as reducing bank profitability is not a great idea and should be the last resort in a situation like this. Secondly, the impact on price (interest rates in this case) will be higher if the incidence is determined by elasticity of demand for loans with respect to the interest rate. A full shift of the burden away from the banking system to the user may not be possible, but the objective should be to make the distortionary nature of the surcharge as low as possible.

### Consumer/Commercial Credits - Levels



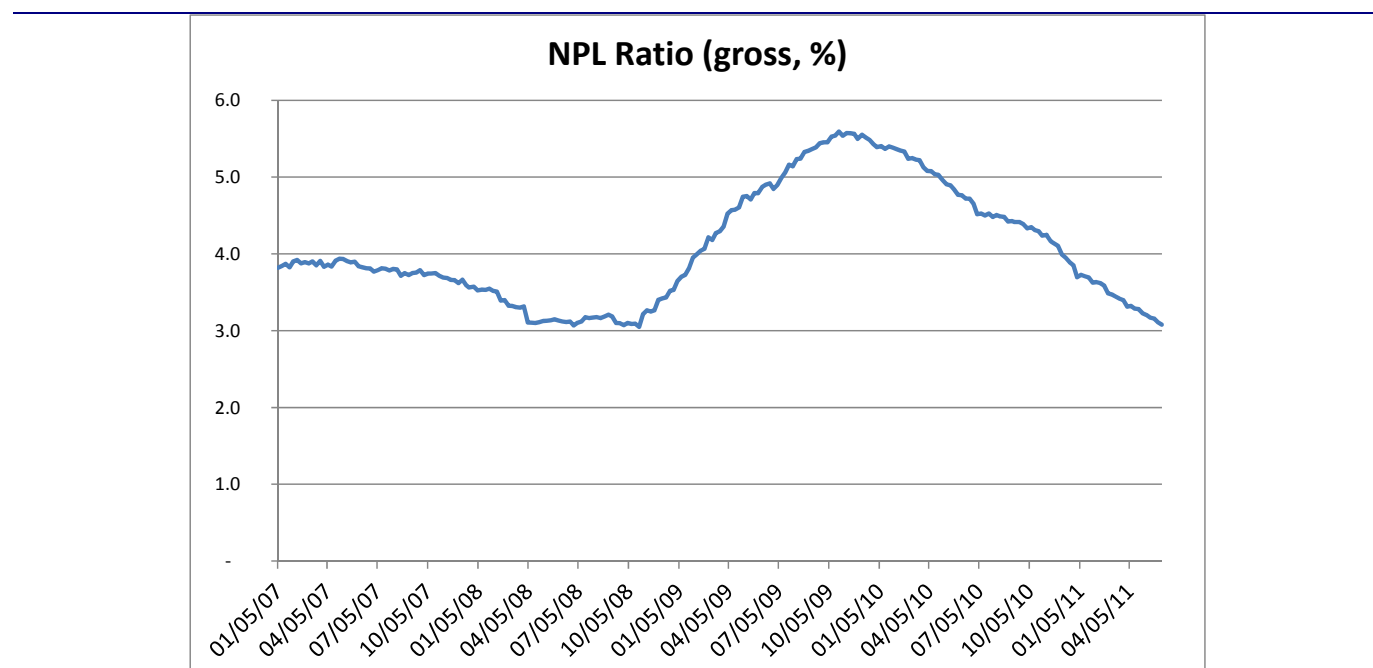
Source: Central Bank of Turkey, Yapı Kredi Economic Research

### Consumer Credit Volume (\*)



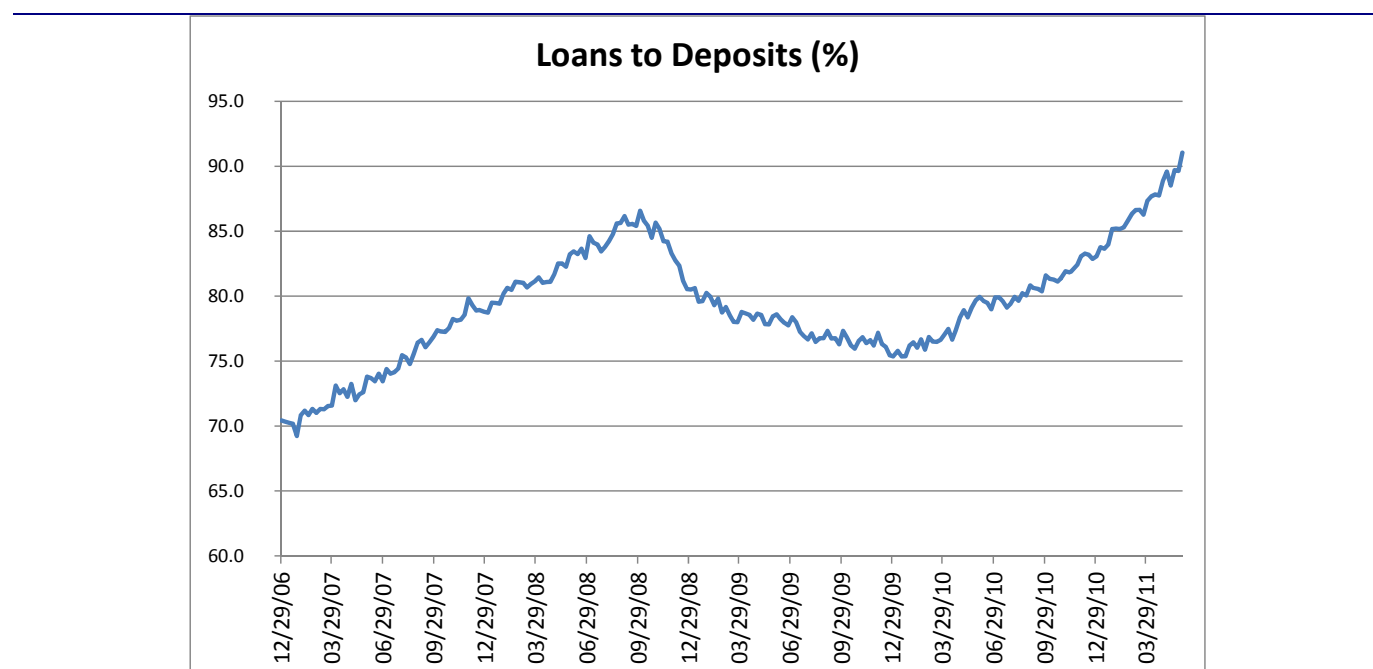
Source: Central Bank of Turkey, Yapı Kredi Economic Research  
(\*)Weekly % change of 8W average

## NPL



Source: Central Bank of Turkey, Yapı Kredi Economic Research

## Credit/Deposits Ratio

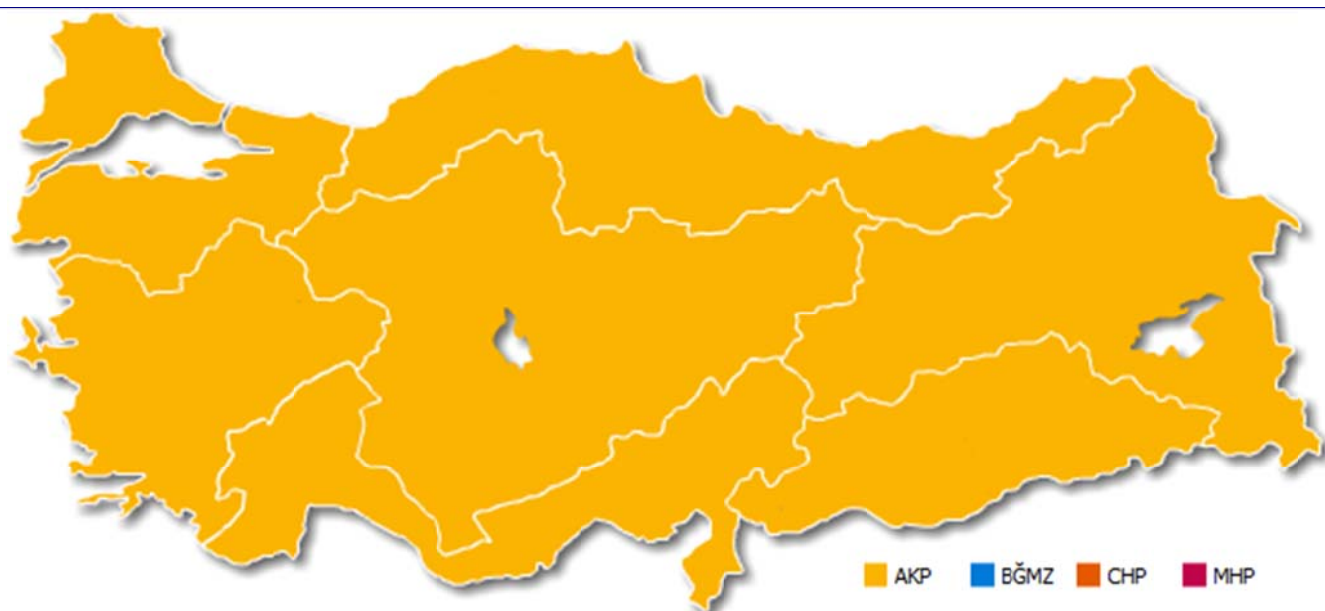


Source: Central Bank of Turkey, Yapı Kredi Economic Research

## 1.4 Appendix

### 2007 Leading Parties by Region

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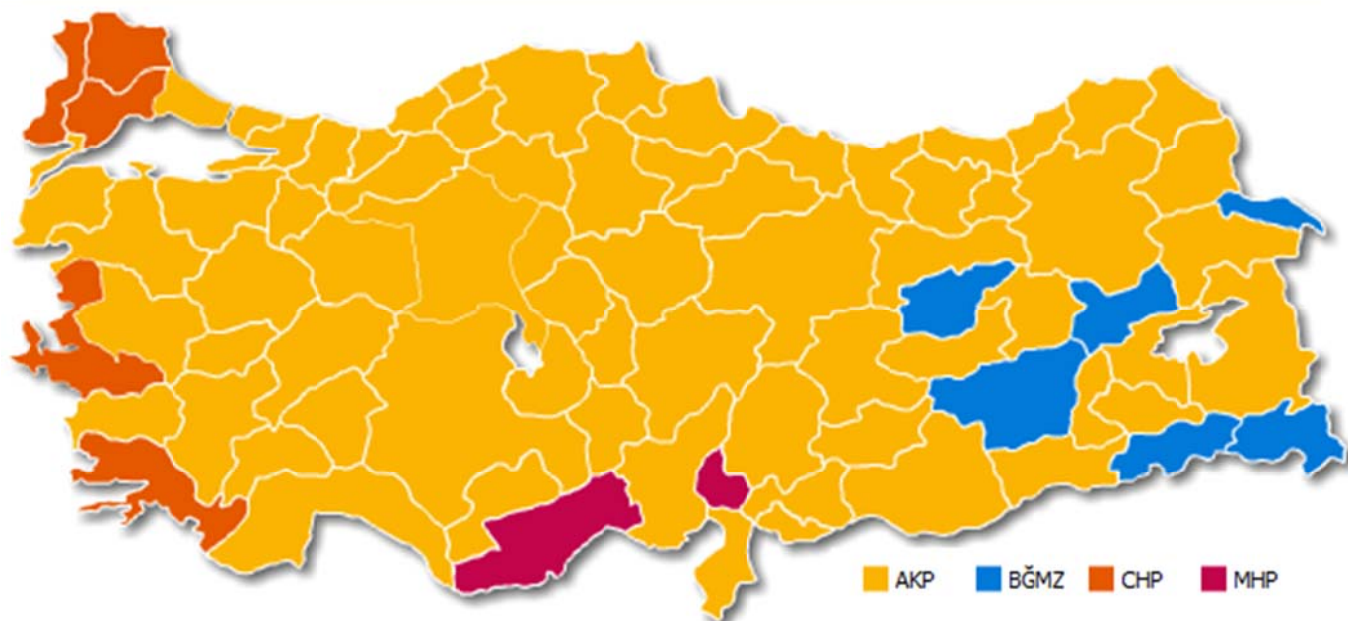


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Source: NTVMSNBC

### 2007 Leading Parties by City

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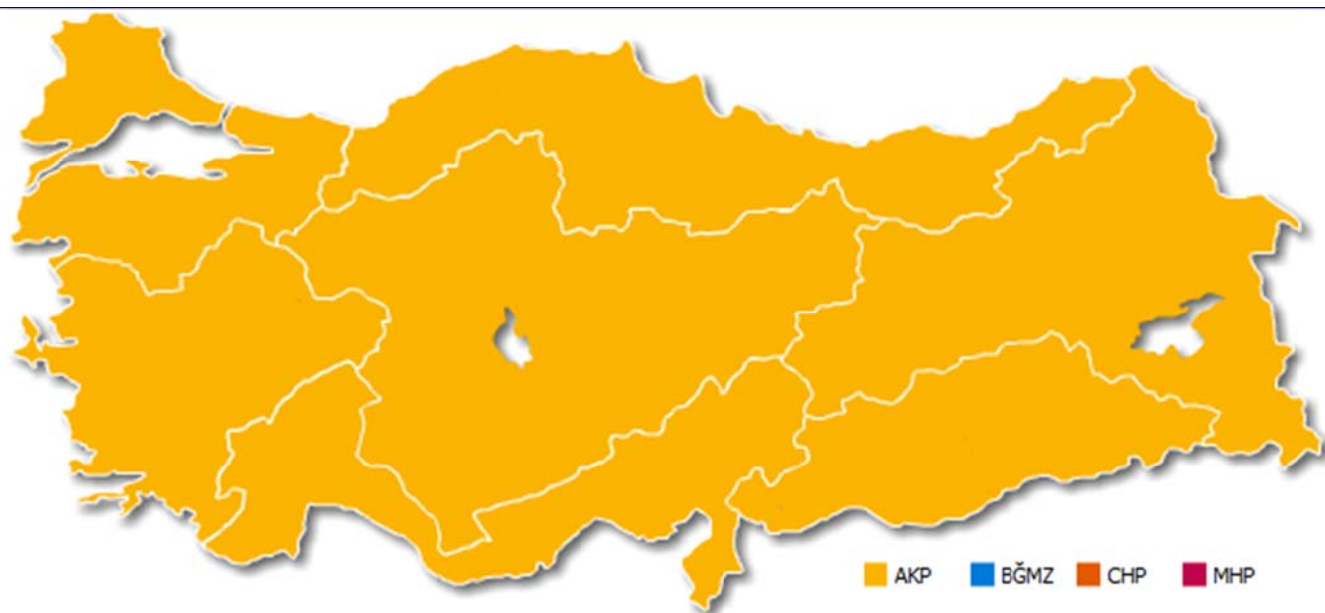
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Source: NTVMSNBC

\*BGMZ stands for the BDP + Independent Socialists Coalition

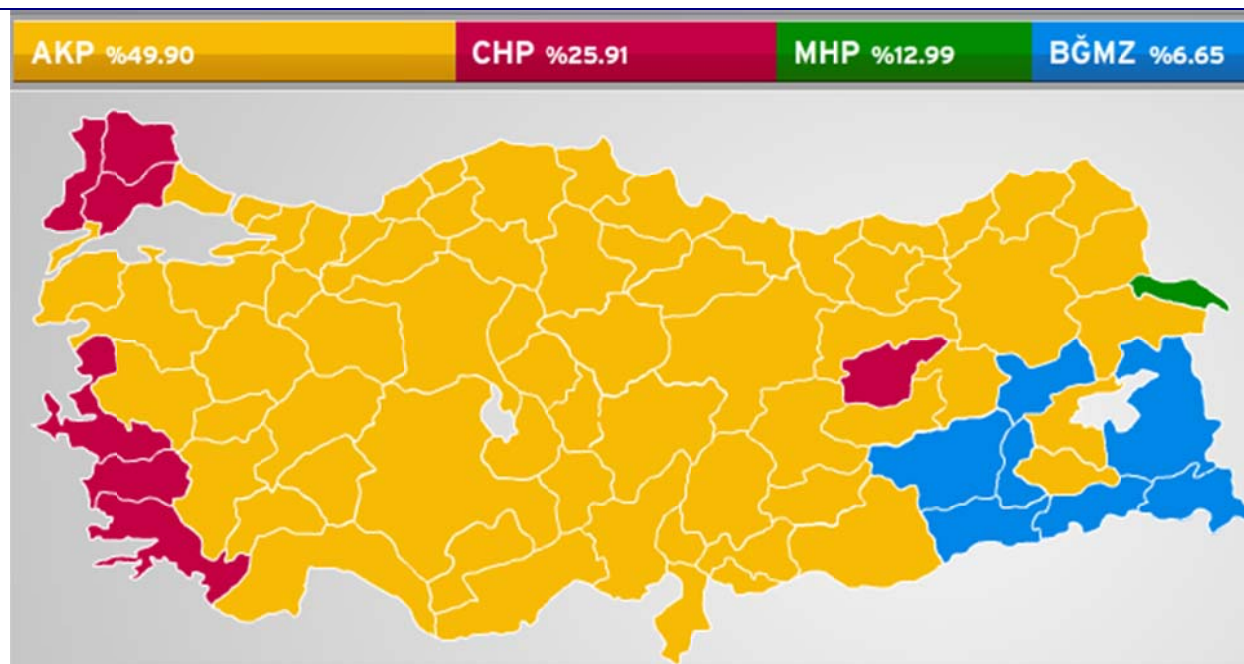


### 2011 Leading Parties by Region



Source: NTVMSNBC

### 2011 Leading Parties by City



Source: NTVMSNBC

\*BGMZ stands for the BDP + Independent Socialists Coalition

## Markets

by *Murat Berk / Economist and Investment Strategist*

### Still Marching Towards a Macro Trap

*"Nothing is harder to see into than people's nature. The sage looks at subtle phenomena and listens to small voices. This harmonizes the outside with the inside and the inside with the outside".*

*"The proper course of military action is to establish strategy first, and then carry it out."* Zhuge Liang

*"The bold will readily clash, readily clash without knowing what is to their advantage."*

Liu Ji

In classical Chinese strategy, the military way is not always a means towards achieving gains, but more often towards survival. For example, as deep strategy thinkers such as Sun-Tzu, Liu Ji and Zhuge Liang note in their discussions of the importance of forming alliances in certain situations, political means are applied in pursuit of military ends and not the other way around (which seems to suggest the opposite of the Clausewitzian framework).

Also, in classical Chinese strategic thought, the concept of war and victory is centered on the psychological. This thought is twofold: it both emphasizes psychological victory and the psychological preparation required for victory. For example, Sun-Tzu opines: "...one who knows the enemy and knows himself will not be endangered in a hundred engagements." Special emphasis is on mental preparation and other "intangibles".

Markets are similar in many ways and psychology and other intangibles are quite important and so is survival/preservation of capital. For example on one hand we have the financial elites telling Greece to vote for further austerity, which is necessary based on their debt sustainability models. On the other the political/mental issues on the ground seem to be quite different. I guess everyone's aware Greece can't maintain it's membership of the Euro without internal and possibly painful devaluation. How to reconcile so many contradictory positions?

It seems like most professionals are high frequency short run macro data and market price driven, without much tolerance for macro analytical frameworks to use when making medium term investment decisions. It seems like it is just a PlayStation game for many, where they trace and extrapolate the recent momentum, otherwise known as Recency Bias, and then find "fact/fundamentals" to justify the developments ex-post.

Thus, it may be interesting to apply some less utilized frameworks as a thought exercise. For example the framework made popular by the late economist Wynne Godley and made more topical by Rob Parenteau.

In this framework, the analysis of sector financial balances takes center stage. In a nutshell, for the economy as a whole, total income must equal total expenditures. Total saving out of income flows must equal total investment in tangible capital during any period. For individual sectors of the economy, these equalities need not hold. For example, governments can spend more than they earn— they can run a fiscal deficit. Households can spend less they earn in income — they can run a surplus, or net saving position. The financial balance of any one sector can be in surplus, in balance or in deficit but regardless of how many sectors we split the whole economy into, the sum of the sectoral financial balances must equal zero. For example, if we divide the economy into three sectors — domestic private (households and firms), government and foreign — the following equation must hold true:

Domestic Private Sector Financial Balance + Fiscal Balance + Foreign Financial Balance = 0

And after some simplifications we can arrive at the following:

Domestic Private Sector Financial Balance + Fiscal Balance - Current Account Balance = 0

Please keep in mind this is an accounting identity, not economic or financial theory.

We have been fairly convinced (and so far successful) about our understanding of the basic framework of what has been and is driving economies and markets. Perhaps more importantly, a forward looking view must not only focus on past data but utilize a flexible framework, willing to incorporate and adapt to changing circumstances, and formulate views on what could happen to key drivers.

Thus, I've come to the conclusion that another piece of the current market puzzle may be related to policy decisions to influence the financial balances of the public vs the private sectors, or what I've previously called the big macro trap.

Without delving into any details here, looking at the above accounting equation we can clearly see that it is not out of question that an aggressive fiscal retrenchment coupled with aggressive policy moves aimed at slow down at this point in the cycle could overshoot/backfire and place the private sectors on a messy deleveraging path — the very outcome policymakers were attempting to prevent just two years ago. So is aggressive fiscal tightening really the right policy solution?

This may sound optimistic, pessimistic, irrelevant, etc. I think this line of thinking deserves some thought and scrutiny.

There is a lot of talk on the bullish side of how markets are due for a bounce, and how levels of pessimism are too high. Normally I would agree but given my above concerns regarding the macro trap, I feel this talk may be working off the wrong framework.

In other words: If all signs pointed toward continued global growth/just a soft patch and a continuation of the general background, then yes, this dip would be "a great buying opportunity."

But if markets are being forced to re-price for global growth slowdown and a contagion from European debt "issues" amid local measures to slow down growth (amid a general/global growth slow down) then this is not a buying opportunity... but rather an opportunity to sell on rallies before the whole thing goes much lower.

Thus, I think the reward to risk in this market is still skewed to the downside and many are still caught long. If data and external shocks threaten to worsen, the prospect of a "waterfall decline" is very real, in my personal view. Thus, on markets, my views have not changed and I maintain my shorter term bearish view and continue to ride profits on bearish positions.

*"There may be equilibrium, which though stable, is so delicately poised that, after departure from it beyond certain limits, instability ensues, just as, at first, a stick may bend under strain, ready all the time to bend back, until a certain point is reached, when it breaks. This simile probably applies when a debtor gets 'broke,' or when the breaking of many debtors constitutes a 'crash,' after which there is no coming back to the original equilibrium. To take another simile, such a disaster is somewhat like the 'capsizing' of a ship which, under ordinary conditions, is always near stable equilibrium but which, after being tipped beyond a certain angle, has no longer the tendency to return to equilibrium, but, instead, a tendency to depart further from it."*

Irving Fisher, "The Debt-Deflation Theory of Great Depressions" (1933, Econometrica)

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