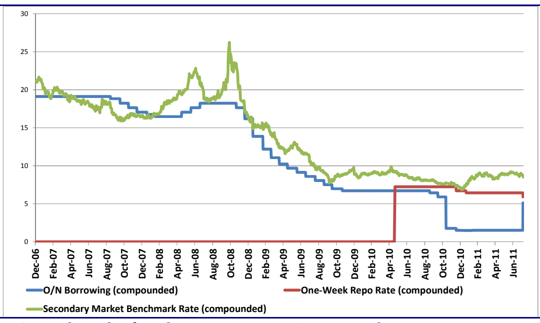
Macro Update

Turkey Weekly Macro Comment

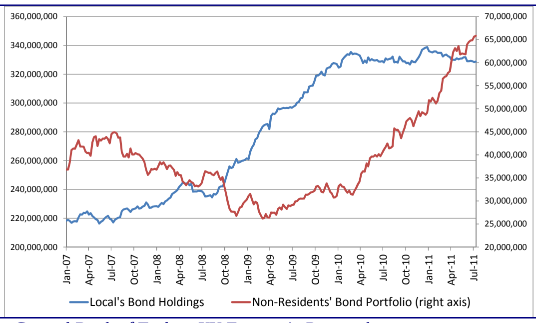
8 August 2011

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

Message Communicated, Messenger Ex-communicated

- The CBRT was about to create believers out of heretics, but the announcement of a rate cut in last week's MPC meeting that amounted to net-net slight easing (in the presence of some other measures entailing tightening) led to a second round of revolts a la December 2010.

- It is more of the same in this recent case it seems, and one can only hope that it takes less time for the market to adapt the mental framework of the CBRT than it did in the first case in December. The CBRT credibly signaled that it is watching global outlook very closely and preparing packages for contingent states of the world. Current market indicators either suggest that markets are not convinced by the appropriateness of the CBRT measures for the prevailing environment or that global outlook is perceived to be much more dismal than it is perceived by the CBRT.

- Inflation outlook is more benign than perceived by markets and core inflation threat is overdone, we believe (notwithstanding a possible rise in core inflation going forward).

- IP numbers for June released this morning further strengthened the hand of the CBRT in defending its strategy, but the data was mostly bypassed in the day's hectic environment in markets.

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Message Communicated, Messenger Ex-communicated

The CBRT had announced last Wednesday that it would hold an emergency meeting the next day, and market analysts either welcomed or remained indifferent to the announcement. That in itself was a huge leap of faith as far as markets were concerned as CBRT bashing had become a national pastime for most analysts and for quite some time. We have to admit that some doubters of CBRT policies were becoming much more lame in their criticisms in light of the most recent global and local data, but none went so far as to claim that the CBRT had come up with the proper design as of last fall as that would be tantamount to repentance or contrition. Thus, the CBRT was almost about to create believers out of heretics, and the extraordinary meeting announcement was greeted with admirable calm by market participants most of which happen to be CBRT doubters to say the least.

The MPC announcement that came the next day amounted to net-net slight easing in monetary policy and it led to a second round of revolts a la December 2010. The package announced comprised narrowing down of the O/N borrowing/lending corridor as expected, some arrangements regarding repo auctions which are likely to have some impact within the banking sector itself (largely ignored though it may have significant impact on a bank-specific basis), some warm-up phrases on FX liquidity management pointing at defending the TL, AND the infamous policy rate cut. The last component of the package either created turmoil among heretics or was mostly doubted (misunderstood) among transformed mild doubters of late. Here are a few excerpts from various houses, and none looks supportive of the CBRT decisions. We have to say that some intimate e-mailing that took place between market participants directly demanded ex-communication of the CBRT from the Church of Economic Literacy and the following remarks sound extremely lame compared to those.

"What surprised us was the bank's decision to cut the policy rate rather than the reserve requirements, which would have injected additional TRY liquidity directly into the domestic banking system and provided some strong support to the local rates market."

"While the CBT attributed the latest 50bp cut for the policy rate to the risk of facing recession due to intensifying global problems, the recent macro data flow indicated that there is little reason to suppose domestic demand will lose any significant momentum any time soon…………..In all, the CBT's 50bp cut for the policy rate looks a bit premature rather than pre-emptive in an environment where domestic demand has yet to cool-off, current account deficit has yet to stop expanding and FX market liquidity conditions set to tighten."

" To be frank, we have no way of justifying the rate cut. True, growth has taken a breather in Q2 after the rapid pace of the previous two quarters, the global growth outlook is looking uglier, and central-banking, after all, is about being pre-emptive and forward-looking (given the policy lags and so on). But why the rush, especially when a weaker economy could come handy in containing the CAD and

steering inflation toward the 5% medium-term target, and hence, even helping to snatch a rating upgrade? Well, the only answer we can come up with is that, growth is all that matters to the Bank."

"Alert: Turkish Banks - CBT Cuts Policy Rates: Entering the Twilight Zone……In the statement accompanying the rate decision, the CBT attributed the need for a more expansionary policy stance to limit the potential adverse impacts of the ongoing sovereign debt crisis in Europe on the domestic economy. While we believe that there are no signs of a meaningful decline in domestic economic activity to support the rate move, we also think that the move doesn't bode well for the inflation outlook and financial stability as long as the TL remains under pressure."

"We are worried that the CBRT has assumed an unnecessary risk by betting so strongly on a global recession. It could make sense to take these measures more smoothly and we believe that this decision could hurt the CBRT's credibility at least in the short term.In any case, it is not clear how the cut in the benchmark rate will achieve the stated aim of boostinggrowth. As we've argued for some time, a combination of higher bank reserve requirements and limited liquidity provision via repo auctions has led to a rise in market interest rates since the start of the year, in effect causing monetary conditions to tighten. (See Chart 2.) Unless reserve requirements are now cut orthe size of repo auctions is raised, the reduction in the benchmark interest rate is unlikely to ease monetary conditions and boost growth. More importantly, even if this does happen it will only serve to reflate a nascent credit bubble that policymakers had previously been trying to cool."

"It is crystal clear: TCMB's global macro bearishness has landed. The only constraint the Bank had on fresh easing (local inflation) gave a green light (it was bad, but not bad enough), so the Bank called an extraordinary meeting tomorrow. Some think they will defend the currency, we disagree, as it doesn't make sense with the framework TCMB is looking at the world and looking at Turkey. They will ease monetary policy, in our view, as signalled on the inflation report, come across dovish and narrow the corridor as a supplement. For those of you with a slightly longer time horizon, Q4 re-acceleration of domestic demand, will make it tough for Turkey as "overheating" debate with heaten up with a rise in service price inflation, but for now, TCMB rules the day in its postmodern way."

One common perception is that the policy rate cut was WRONG though for different reasons. Some expected RRR measures to be reversed instead of a rate cut. But the CBRT has been insisting for some time that it was not the deceleration in growth but the composition of the slowdown that was more worrisome for them. It is global outlook rather than the gradual cooling in the Turkish economy that bothers them; hence they opt for a policy rate cut rather than RRR reductions which are still functional in providing an orderly slowdown in domestic demand. Had it been the case that global outlook was seriously improving but domestic demand was unexpectedly turning sour, the very same composition approach would have necessitated a reduction in RRR and no change in the policy rate.

As for no meaningful signs of a slowdown argument, it begs for an explanation as to how the same statement is put forth today as obstinately as it was five months ago. This is pure ignorance stemming from overconfidence and lack of self-correction in light of data that hurt your claims. How one could deny a slowdown in the making which the CBRT also has been displaying with clarity is truly beyond us.

As a third point, the CBRT does not aim to boost growth. The attempt to keep growth within reasonable limits while focusing on disinflation is quite different from promoting a boosting of growth. That argument is desperately off.

The last remark in our list, the owners of which had the audacity to predict an easing through the policy rate cut, was indeed made prior to the MPC decisions. A re-acceleration of domestic demand in the last quarter of the year and a re-picking up of overheating debate is speculative at best and is not a direct inference of the CBRT claim that inflation will pick up in the last quarter of the year. That claim in itself entails significant uncertainty and to the extent that it is predictive, its predictability is based on base effects rather than rejuvenated economic activity.

The most striking aspect of the MPC announcement and additional measures announced in its aftermath is presumably best illuminated via the third remark in our list. With the exception of the first excessively normative assessment expressed as "….no way of justifying the rate cut", this remark is arguably (one of) the most accurate one(s). Yet this judgment of ours sounds like an oxymoron given that first categorical denial statement there, but such is the degree of separation in Turkey when it comes to CBRT policy assessment. The CBRT and the MPC ended up almost prophetic given what took place in world markets on Thursday and Friday, but the CBRT had indeed been emphasizing the miserable global outlook for a while and had been signaling to markets that it was preparing different packages for different possible states of the world. Reducing the policy rate if necessary was a frequently pronounced policy candidate, yet markets did not treat this option very seriously as they were just adapting to surfacing outcomes of the first package announced in the fall of 2010. The outcomes turned out to be perfectly in line with CBRT predictions made roughly eight months ago which ran totally counter to markets' intuitions/expectations/"acquired" perceptions.

The practical problem with the second package announced last week, at the risk of sounding speculative a bit (we do not claim to be mind-readers), seems to be the following. Most market agents gradually came to the point of admitting that there may not have been any overheating in the economy after all, but uttering this would still sound like repentance or even contrition. Thus the launching of a mild easing process (that entailed multiple objectives) was treated like an appetizer offer instead of digestive liquor following a heavy meal which was thus found inappropriate for the occasion. That sentiment presumably underlies the initial negative knee-jerk reaction to the announcement last week.

How do we assess the MPC announcement and the accompanying complementary measures brought in its aftermath? We believe the objective of the package was three-fold:

i) Narrow down the O/N borrowing-lending corridor to render liquidity management more effective in case of worsening global conditions and to reduce somewhat the depreciation pressure on TL

ii) Introduce additional FX liquidity measures to handle short-term speculative moves on the FX front

iii) Reduce the policy rate (instead of reducing RRR as they would befit a different setting which we described above) which would:
   (a) Offset some of the tightening that measures in (i) and (ii) would culminate in
   (b) Eliminate some of the appreciation pressure on TL that would stem from the very same measures entailed in (i) and (ii).

This was not a defense of TL by design per se, but the anticipation was most presumably some appreciation in TL. Yet the exact opposite outcome has been observed though arguably not for that reason alone. There are a number of possible explanations and some of the adverse reaction could possibly have been avoided. Firstly, there is a knee-jerk reaction to any move by the CBRT particularly if there is any touch of heterodoxy in it. And there was some here needless to say. Secondly, the announcement made reference to possible additional FX measures to be announced based on developments in the "upcoming periods" and on "perceived necessity by the CBRT". The auction announcement came roughly 20 minutes after the MPC announcement was put on the web site of the CBRT. By that time, TL had depreciated discernibly and the forthcoming auction announcement appeared (to some at least) to be a desperation move by the CBRT. Reductions in RRR in FX deposits were announced the next day and simultaneity in announcements pertaining to FX liquidity were thus not made simultaneously. More importantly, FX liquidity measures were not taken contemporaneously with other measures put into effect. There is no way to know what kind of difference simultaneity would have led to, but the desperation perception could probably have been avoided. Given that FX interventions in any form do not necessarily signal strength in any conceivable setting, they become even less effective when a "back against the wall" perception reigns.

A positive point on the part of the CBRT that needs to be emphasized is that they recognized the need to inform markets a.s.a.p. instead of waiting for five business days. A more detailed explanation came from the CBRT this morning, and Governor Basci showed up on CNBC for an approximately one hour interview. Our take is that it was one of the most satisfactory and illuminating interviews we ever heard from any Turkish bureaucrat, but this may not be the consensus among market participants as they will continue to doubt the CBRT, its Governor, and its research for all the wrong reasons. This is how we had put it last week when we discussed the regular CBRT meeting with economists/investors in İstanbul on July 29:

"In short, the market doubts the CBRT, has always doubted it since 2006, and will continue to doubt it regardless, which is indeed fine, and much better than the other extreme option of not doubting it at all. The problem, however, seems to be that the market never doubts itself."

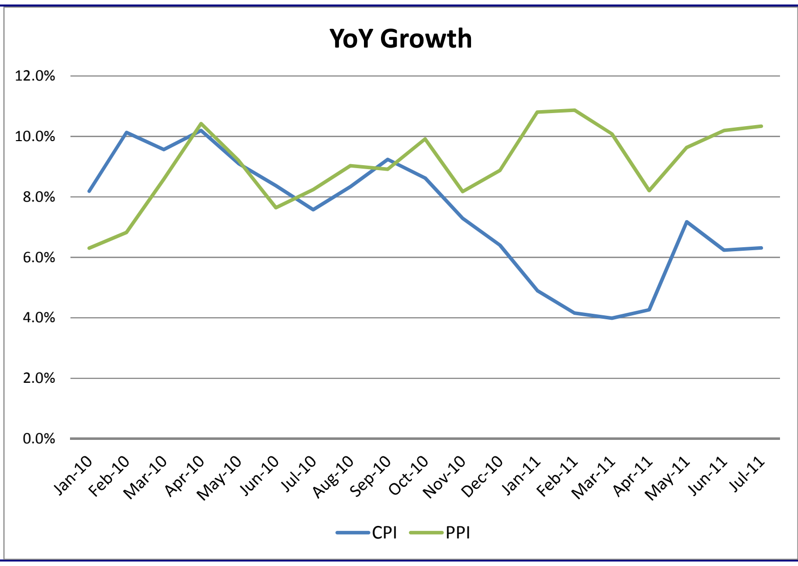
It is more of the same in this recent case it seems, and one can only hope that it takes less time for the market to adapt the mental framework of the CBRT than it did in the first case in December. The CBRT credibly signaled that it is watching global outlook very closely and preparing packages for contingent states of the world. Current market indicators either suggest that markets are not convinced by the appropriateness of the CBRT measures for the prevailing environment or that global outlook is perceived to be much more dismal than it is perceived by the CBRT. It is ultimately a huge test for the CBRT and if it survives this one too, credibility gains are likely to be immense.

Macro Data

Inflation in July came out lower than expected at minus 0.4% (or was it expectations turned out higher than realizations?) and markets by and large took this as provision of room for the CBRT to take away some of the tightening in liquidity. There seemed to be no problem with the perception until the CBRT acted on it as we explained in the MPC announcement discussion above. It did, and the move was not deemed credible.

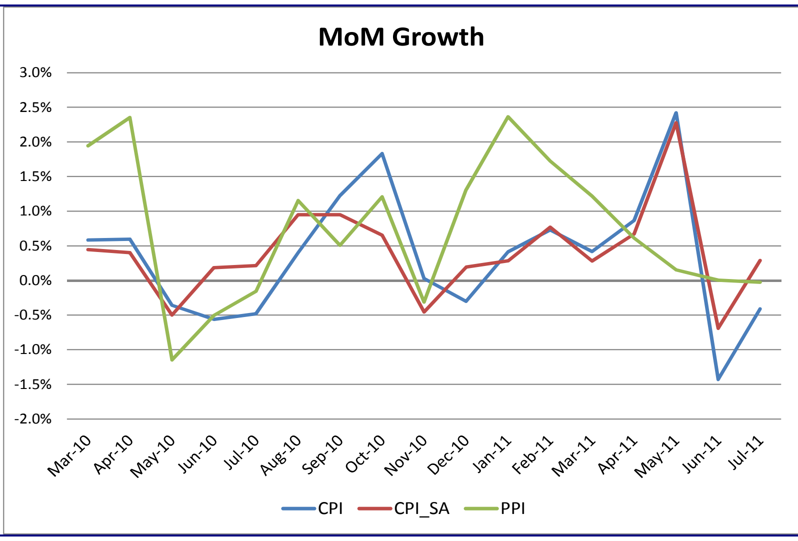
YoY inflation was roughly intact at 6.3% and the CBRT forecast of 6.9% for year-end looks quite reasonable to us but is a lower bound value for market expectations (we are over the cliff at 6.8%).

YoY Inflation



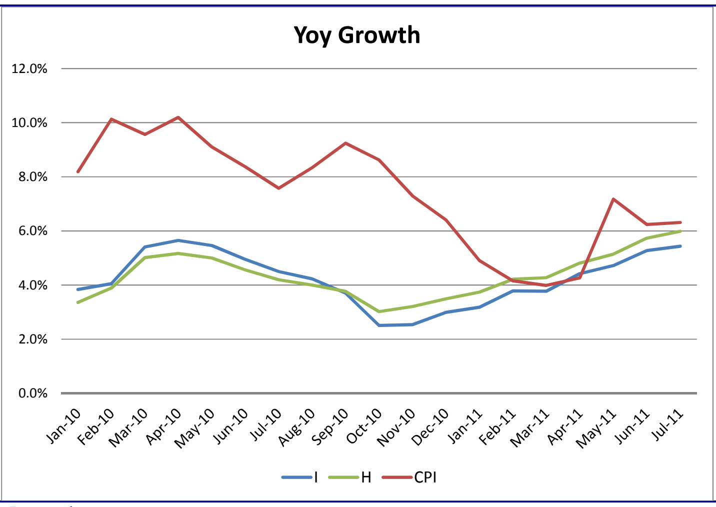
Source: TURKSTAT

MoM Inflation



Source: TURKSTAT

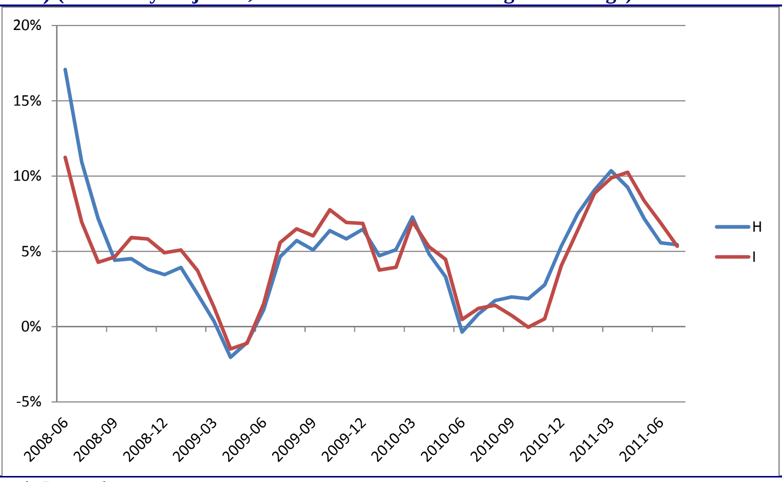
H an I Special Indices



Source: TURKSTAT, Yapı Kredi Economic Research

Core inflation is marketed as the main risk factor by CBRT doubters but the seasonally adjusted, annualized 3-month average percentage change chart below depicts a more benign picture than doubters would like to see.

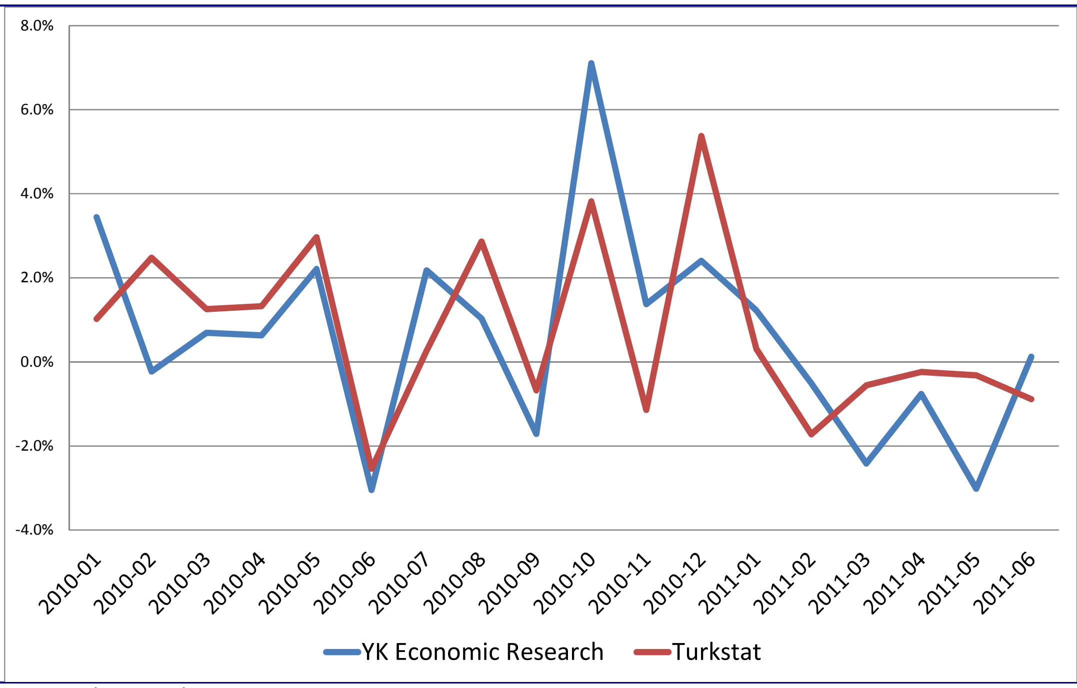
Core Inflation Indicators (H & I) (Seasonally Adjusted, Annulized 3- Month Average % Change)



Source: TURKSTAT, Yapı Kredi Economic Research

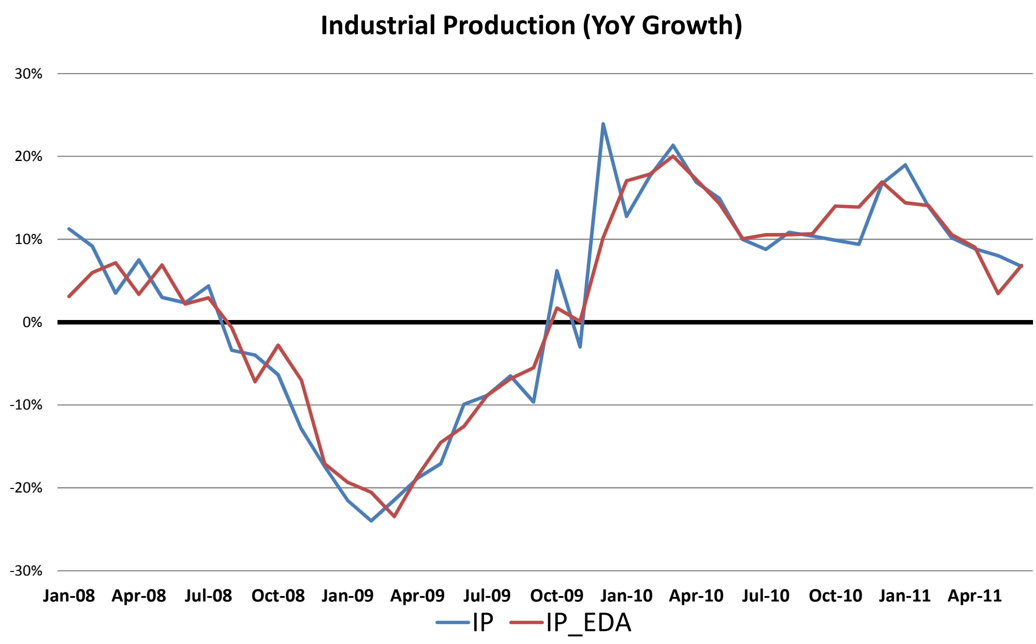
IP numbers for June released this morning further strengthened the hand of the CBRT in defending its strategy, but the data was mostly bypassed in the day's hectic environment in markets. It is nevertheless the fifth consecutive mom reduction in IP and should contribute to further discount of overheating arguments if any are left.

Industrial Production-Efective Days & Seasonally Adjusted Series MoM Growth



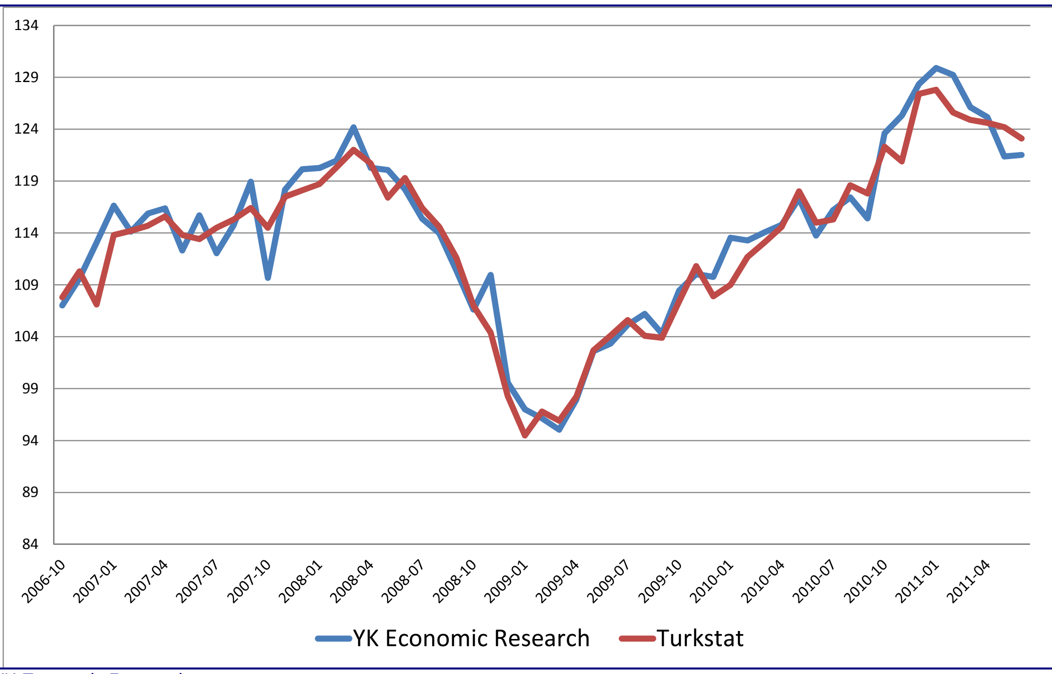
Source: Turkstat, YK Economic Research

Industrial Production YoY Growth



Source: Turkstat, YK Economic Research

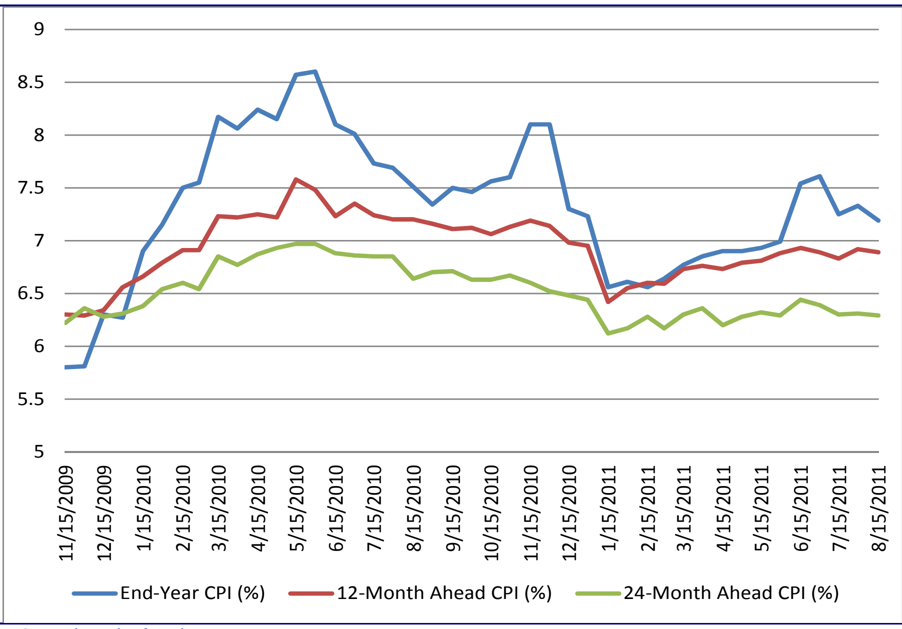
Industrial Production Level (Seasonal and Effective Days Adjusted Series)



Source: Turkstat, YK Economic Research

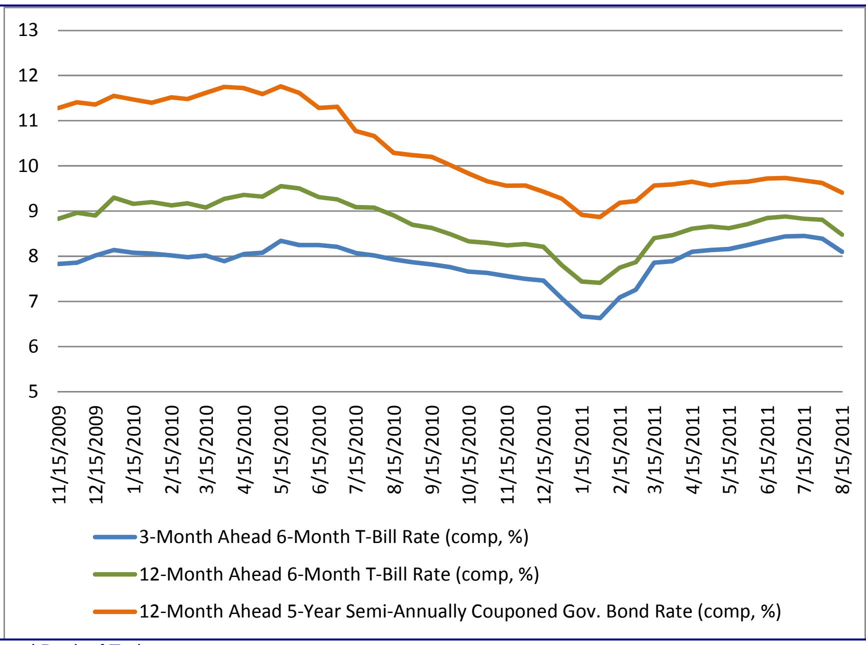
The first expectations survey by the CBRT contained hardly any surprises. End of year CPI inflation came down to 7.19% from 7.33% in the previous survey and policy rate expectations edged down significantly for all time horizons. Market participants received the policy rate message of the CBRT much more clearly it seems, but inflation expectations continue to be the testing zone though the difference between the CBRT forecast and that of the market has discernibly been reduced.

Inflation Expectations



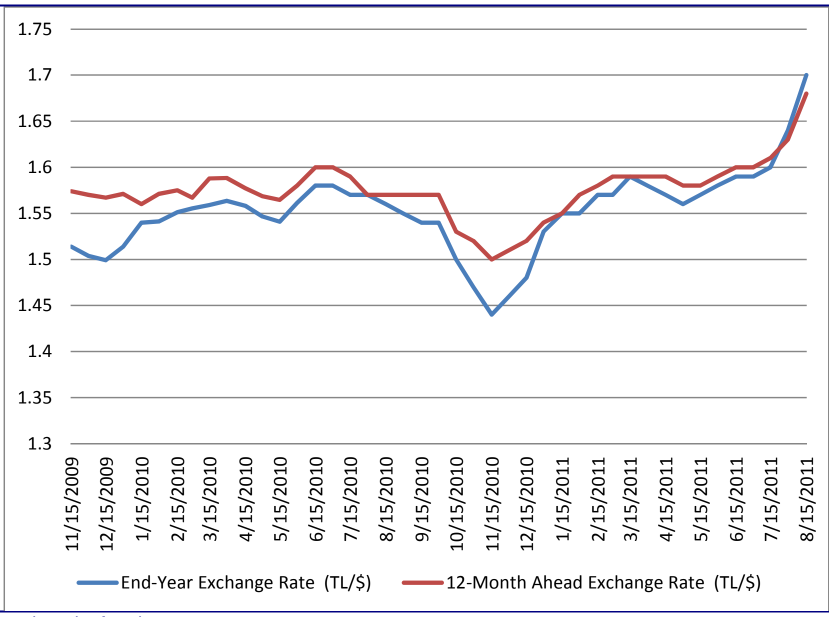
Source: Expectations Survey, Central Bank of Turkey

Interest Rate Expectations



Source: Expectations Survey, Central Bank of Turkey

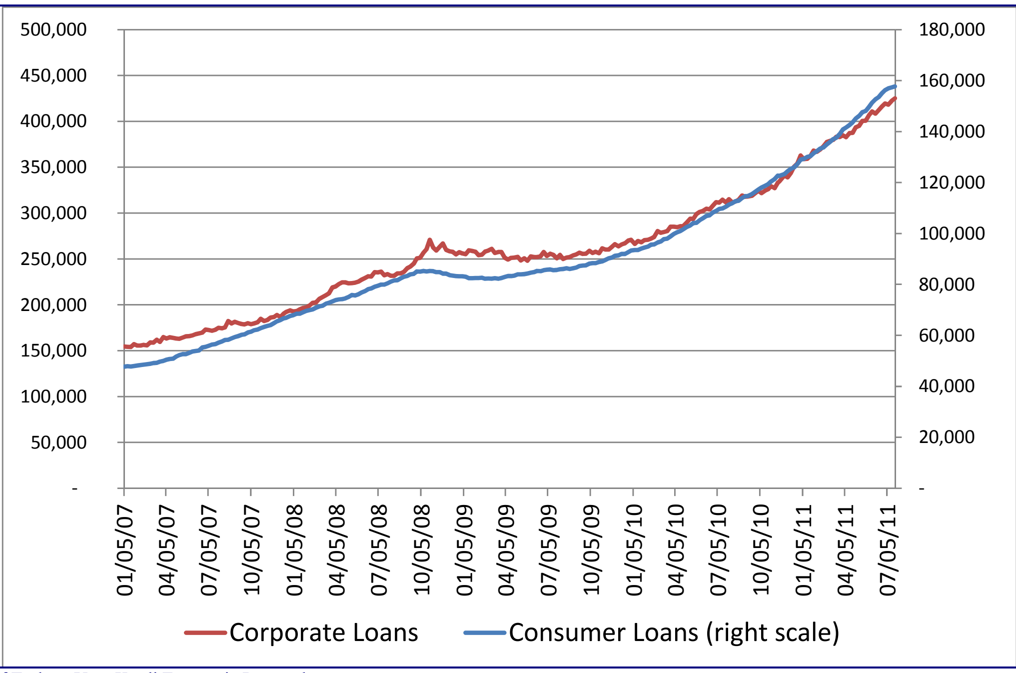
Exchange Rate Expectations



Source: Expectations Survey, Central Bank of Turkey

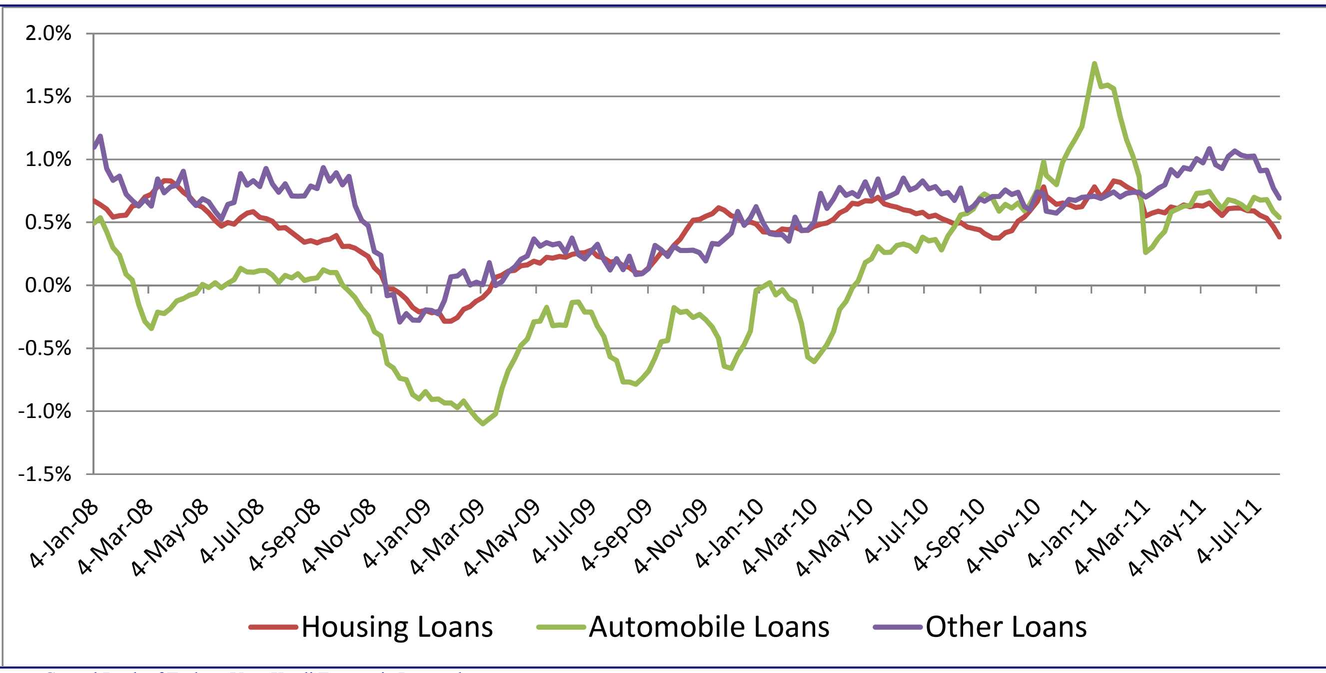
Weekly Data (all weekly data terminate on July 22, 2011 while consumer credits are one extra week updated)

Consumer/Commercial Credits - Levels



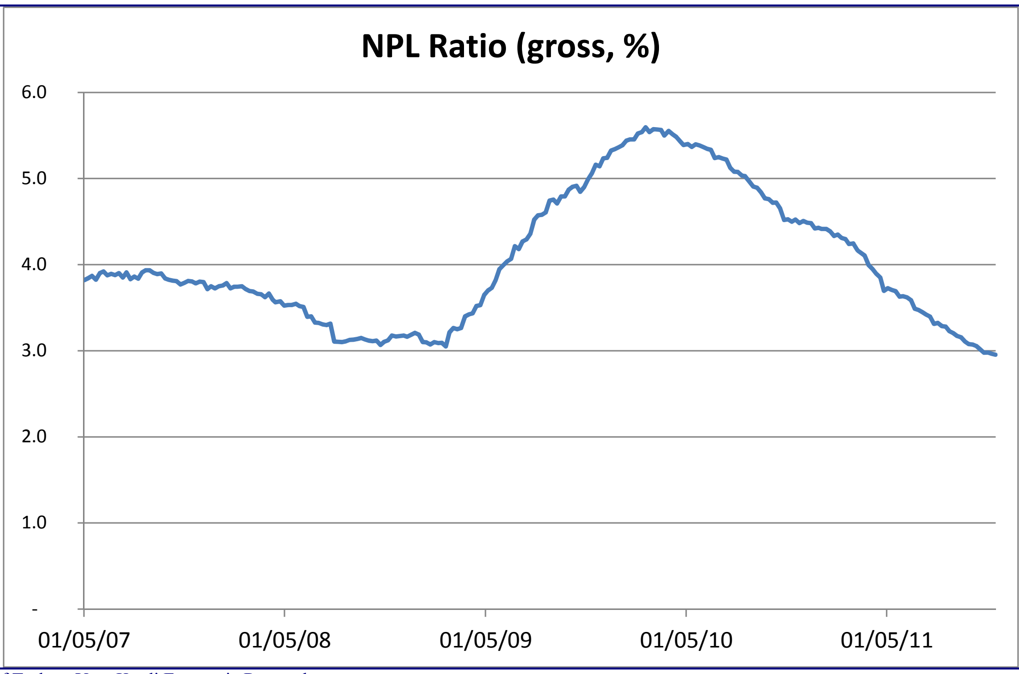
Source: Central Bank of Turkey, Yapı Kredi Economic Research

Consumer Credit Volume (*)



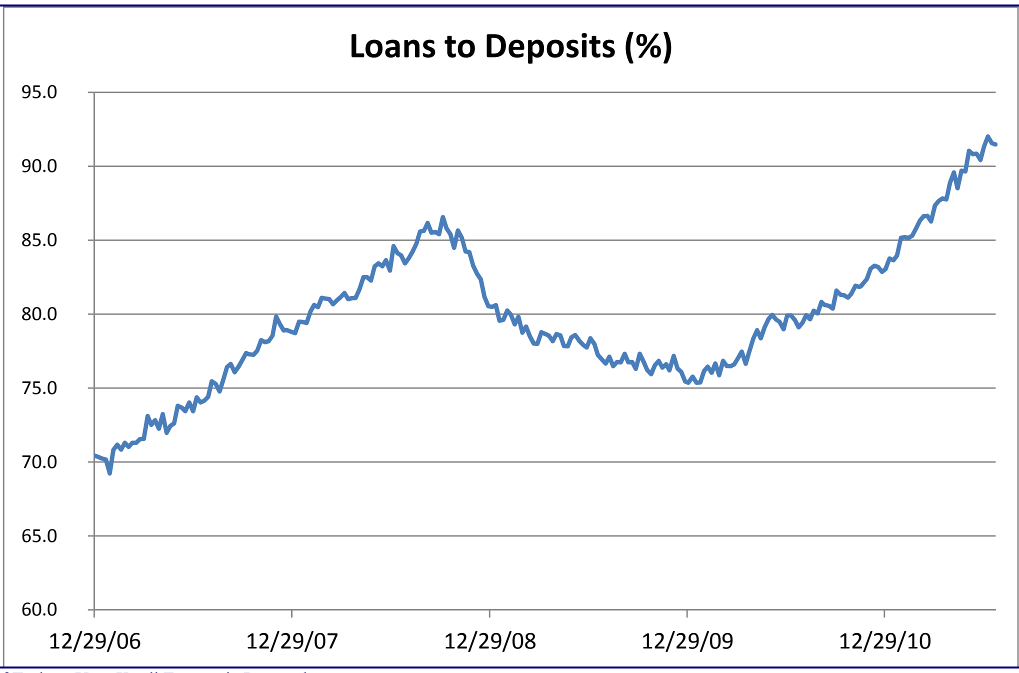
Source: Central Bank of Turkey, Yapı Kredi Economic Research
(*)Weekly % change of 8W average

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

Reality

“We accept reality easily, perhaps because we sense that nothing is real”
Jorge Luis Borges -"The Immortal"

Please refer to my last comments in our weeklies in this space, where I have outlined my market calls for the next few weeks and months. As market developments and price action are very closely tracking the views I set out in my previous notes, I have not much new to add. That said, I want to repeat some points.

With respect to the tactical outlook, in my previous comments, I opined that a rebound from the initial stock market sell-off (before resuming the downtrend) would be forthcoming and went long but suggested that following the rebound, another major sell-off would come sometime in September at latest.

Thus, following the “unexpected rally”, I took profits (went neutral/net flat) and suggested caution. However, I lacked the foresight to switch to a short since the sell-off began earlier than I anticipated.

Here’s what I wrote last week in this space: *“As a tangent, despite the volatile news flow and changing sentiment in various markets, longer-end yields in most places seem more concerned with flagging growth, with bull flattening of the yield curves accelerating to the downside. German 2 year yields also inverted further to the ECB rate (similar to 2008). If history is any guide, this type of yield curve action is generally (not always) associated with more challenging times for economies and stock markets. By late 2011 I think we may all be seeing “the reality” and circular logic of current policies, known as the paradox of thrift, amid a meaningful global growth weakness driven by fundamental demand gaps and policy. By then the market themes and economic issues may have become growth scares amid European debt “issues” and the distorting effect of high credit expansion and misallocation of capital. Also, countries with public finance “issues” will likely suffer from further crowding-out effects, especially as the funding costs of their banks and nonfinancial companies are correlated with their sovereign risks, (as we have seen for example in some periphery Euro zone countries).*

Thus, and as said months ago, following the rally phase I expect to see the beginnings of a major sell-off in global risk assets (which should take the S&P 500 to around 1000) starting sometime September at latest. In this longer lasting global risk-off move I would expect some stock markets to halve from their 2011 peak levels, the USD to rally (initially), sovereign yield curves to bull flatten, and credit spreads to widen (iTraxx Crossover index to above 500".

Thus, things are proceeding largely in line with our contrarian views both in terms of markets and in terms of the key issues/drivers (i.e. growth slowdown, policy, inflation/overheating concerns).

From a macro markets perspective, our medium term views have not changed by recent data and price action. Rather they have added credence to our already existing underlying themes.

In terms of asset allocation, our recommendations have also largely panned out as bonds performed well versus stocks.

My tactical views remain the same. I'm not yet in the camp that this is a buyable correction (yet); instead, if we get a bounce (think around 3-5% from here), it is sellable, in my view.

As I've been saying for months, the more medium term risk, (like it was in 1930s and '08 etc) lies not in stock markets per se, but in reflexivity, feedback loops between perceptions, & reality, liquidity and credit which eventually affects the "real economy" and stock markets.