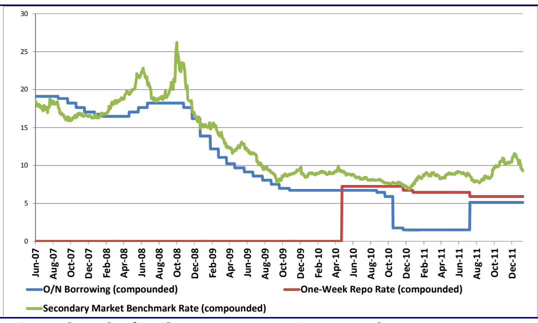
Macro Update

Turkey Weekly Macro Comment

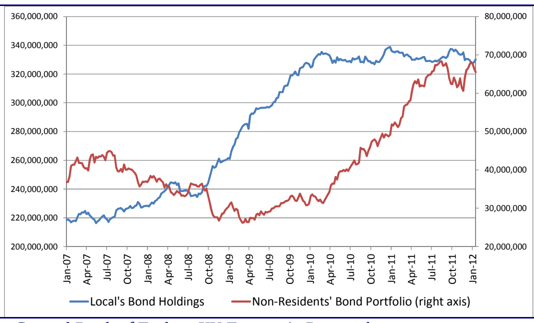
13 February 2012

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

Intuition is Free, Insight is Costly

- Market sentiment and international institutions' forecasts about global outlook do not seem very compatible at the moment although they moved in tandem as recently as a month ago. Markets have been acting in defiance as of late though.
- IP growth figure at 3.7% was further testimony to the slowdown in the economy which is still above market consensus, lending support to our claim that market's output growth forecasts might once again be contaminated by the ever so present negative bias.
- The correction in CAD in seasonally adjusted terms that began last March continues unabated. The pace of correction seems to be bothering most analysts but why they would be expecting a faster pace in the face of concurrent higher than expected growth is a mystery to us.
- YoY credit expansion rates at the end of the first month of the year give rise to some interesting questions which we believe deserve some attentive investigation.

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Intuition is Free, Insight is Costly

Market sentiment and international institutions' forecasts about global outlook do not seem very compatible at the moment although they moved in tandem as recently as a month ago. Then came the Fed announcement, the fiscal pact and the ESM got out of the way, a second LTRO became a sure bet , and markets rallied. While it would be foolish to assume that overwhelming European problems will go away any time soon, it would have been equally foolish to assume that European authorities would do nothing to come up with viable options on the way to reducing the stress on the system. Quite a lot indeed has been done, and yes, there are still formidable problems and some chilling prospects for the area. Yet it may be that markets are coming closer to that mind frame where they choose to opt for assessing the feasibility of long term solutions in an updating fashion, deciding successively at the end of each short term measure as to how the long term feasibility looks. In simpler words, convergence to a solution at (t+n) could look close to impossible at (t) but prudent measures and successful implementation at, say, (t+1) and at (t+2) might make the (t+n) solution look much more feasible. In slightly technical jargon, defining policy success as (S),

$$P(S_{t+n}) \neq P(S_{t+n} / S_t) \neq P(S_{t+n} / S_t, S_{t+1}).$$

Success in short term measures increases the likelihood of success for the long term problem, but that has to be the default approach at the outset which will rightly lead market participants to focus on short term measures with *temporary intended ignorance* of the long term goal. Needless to say we are talking about extraordinary times when we make these claims pertaining to proper time horizon selection.

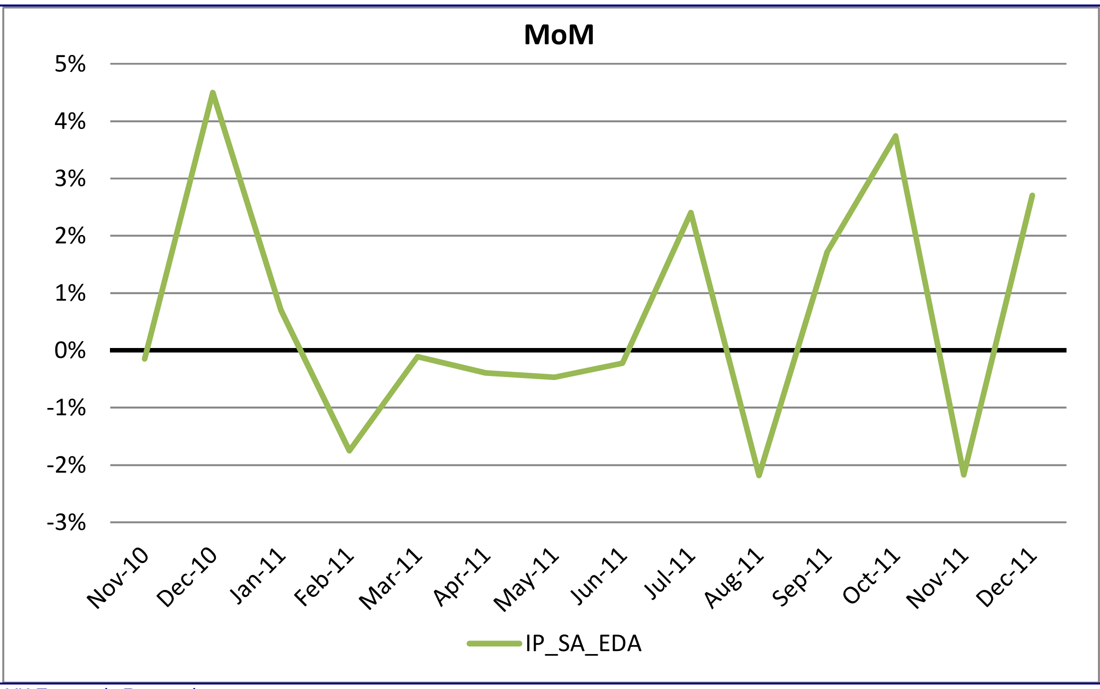
Macro Data

Industrial production figures for January surprised most market participants on the upside very much like foreign trade deficit figures on the downside. Market participants were pleasantly surprised in both cases and our bet is that they will continue to be surprised quite a few times more until they adopt an adaptive expectation formation scheme.

IP growth figure at 3.7% was further testimony to the slowdown in the economy which is still above market consensus, lending support to our claim that market's output growth forecasts might once again be contaminated by the ever so present negative bias. We contend that the IP data itself is quite noisy and that even double filtered growth figures are not immune to that defect. Proper filtering still displays an unequivocal slowdown which is nevertheless quite tamed and not suggestive of a looming recession. [1] Just as there are those who have been claiming that Turkey will be dragged into a recession in 2012, there are also those who contend that growth is gaining momentum in Turkey. We even came across some reports whereby some "lagging indicators" were unintentionally constructed to make the point that IP growth was gaining momentum. Properly constructed trend analyses using frequency domain filters indeed show that IP has been below trend lately. As a technical note, we feel obliged to remind careful readers that moving average analyses can be quite misleading in this type of data.

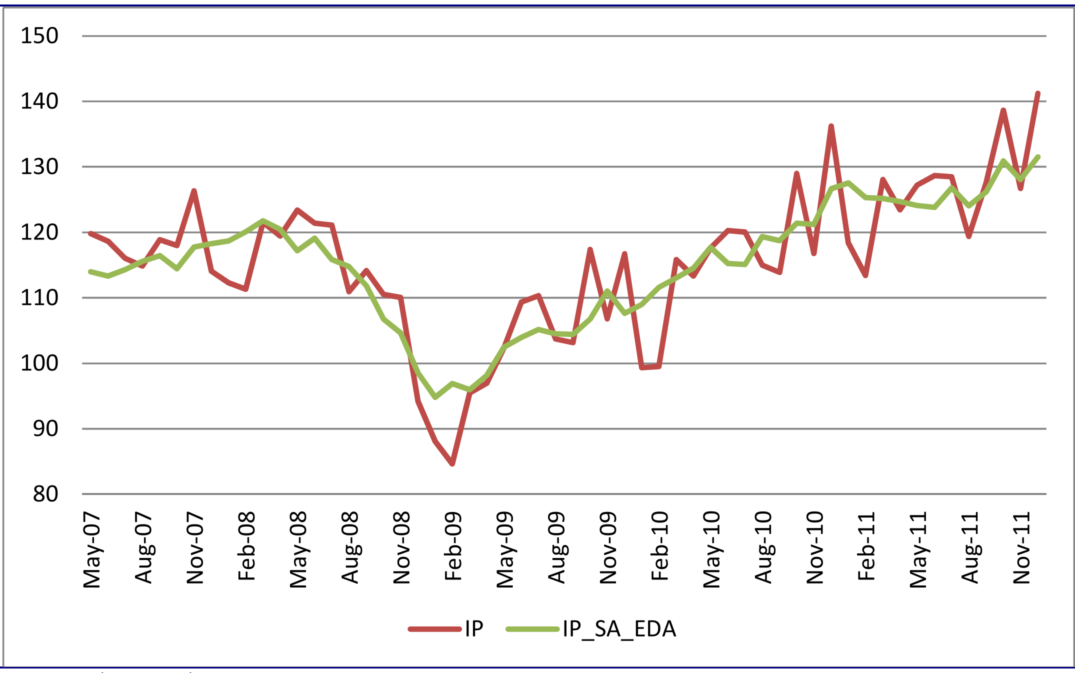
[1] Having obtained the IP figure for the month of January, our research team was able to come up with its core inflation figure which turned out to be 68 bps below the headline (vs. 70 bps in December and 47 bps in November). We expect the gap to widen in the face of sticky headline and declining core in the upcoming few months.

Industrial Production-Efective Days & Seasonally Adjusted Series MoM Growth



Source: Turkstat, YK Economic Research

Industrial Production Level (Seasonal and Effective Days Adjusted Series)

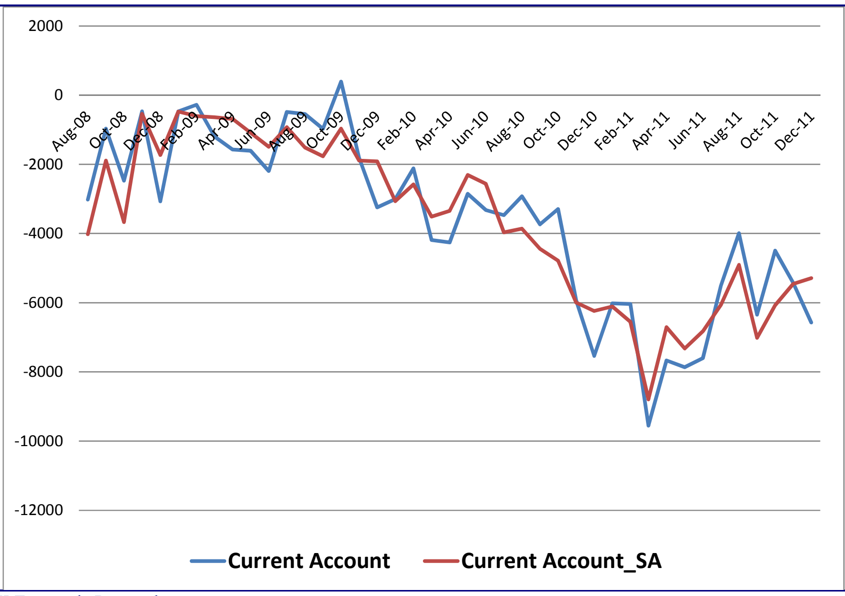


Source: Turkstat, YK Economic Research

Current account deficit of USD 6.6 billion for December 2011 led to an annual figure of USD 77.1 billion for the year. The correction in CAD in seasonally adjusted terms that began last March continues unabated. The pace of correction seems to be bothering most analysts but why they would be expecting a faster pace in the face of concurrent higher than expected growth is a mystery to us. The slowdown in the economy is fairly recent and the impact of the real exchange rate shock on imports is to be displayed with greater lag than before according to our research. These two factors should be suggesting that it would be a bit absurd to see a large reduction in imports and thus in the CAD in the data released so far.

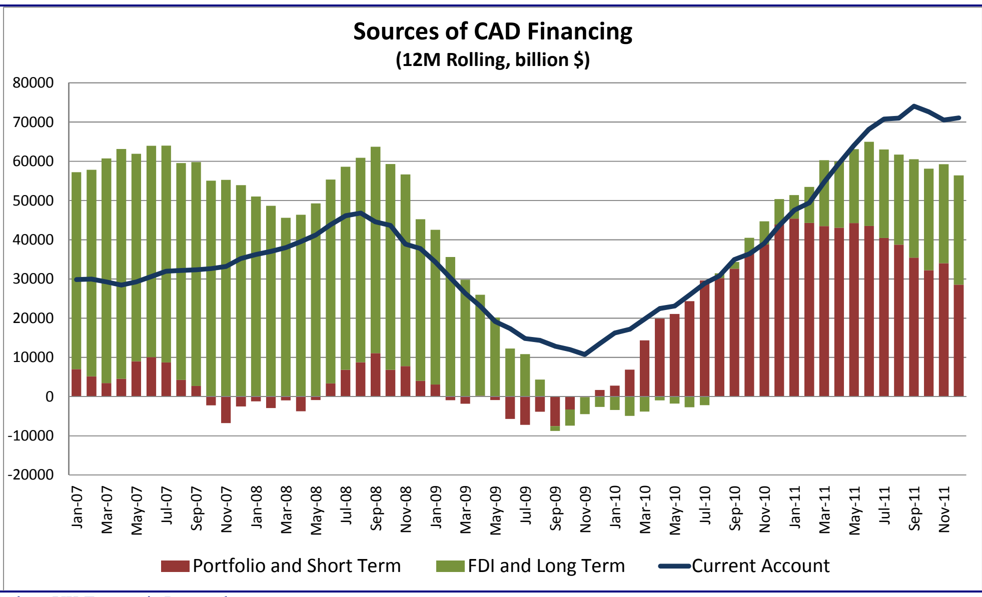
We referred to the perverse nature of the growth dynamics in Turkey in the last three years which, we thought, was naturally accompanied by a perverse CAD dynamics. Those processes will be terminating soon and the transition period will presumably be characterized by discernible growth and positive and/or negligible contribution from net exports to growth which is an anomaly itself for a growing Turkey. That is exactly what we mean by transition period. Put a bit more bluntly, say the growth rate for Turkey in 2012 turns out to be 4 percent. It is quite possible that the contribution of net exports to growth will be positive, or around zero. If 2013 growth turns out to be 4 percent again, you can bet that the contribution of net exports will be a clear negative; testimony to return to "normality".

Current Account Balance



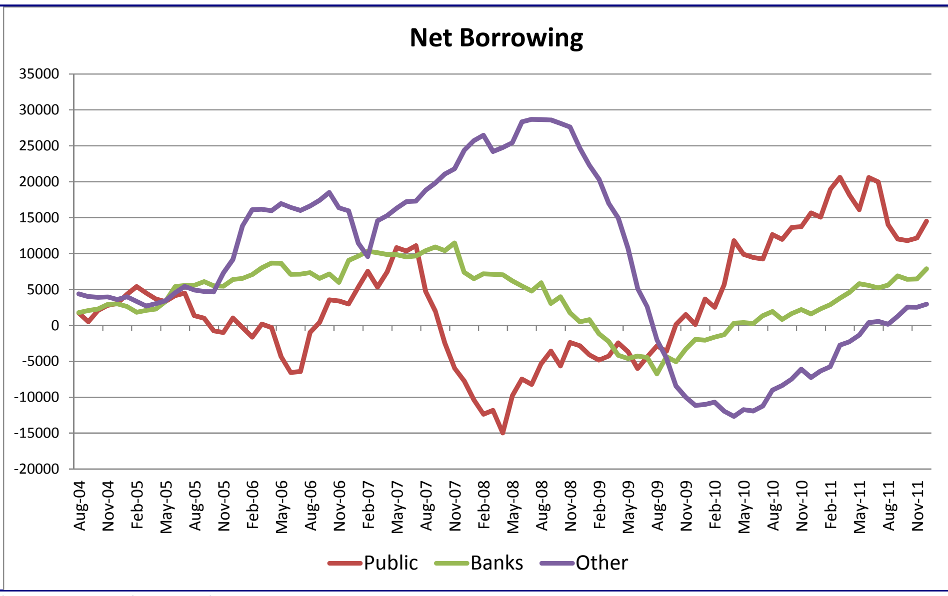
Source:Central Bank of Turkey, YK Economic Research

Sources of CAD Financing



Source:Central Bank of Turkey, YK Economic Research

Net Borrowing – 12M Rolling



Source:Central Bank of Turkey, YK Economic Research

Weekly Data (all weekly data terminate on January 27, 2012)

Consumer loans had another lackluster performance in the first week of February and YoY growth in consumer loans stands at 26.6%, very close to the 25% target that the authorities had set for 2011. At the end of August, the same growth rate had stood at 40.3% and monetary policy had been assessed as total failure by most market analysis because of the failed attempt to bring down credit expansion rate. We have a totally different picture at the moment. Two questions need to be asked at this juncture, we believe:

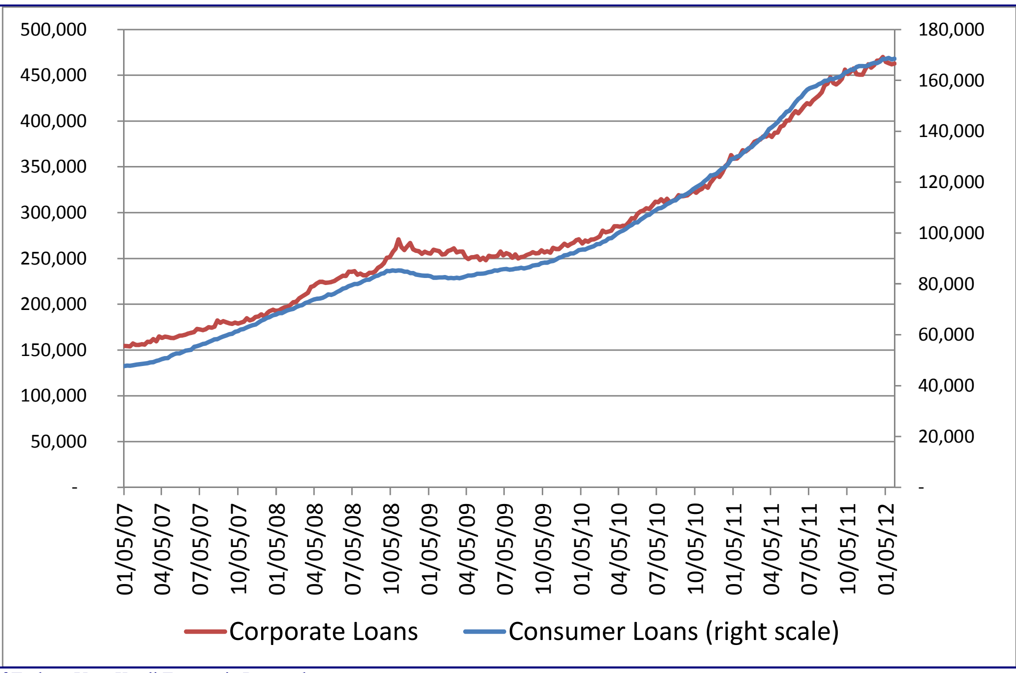
i) How much of this reduction in credit expansion rate is policy induced and how much is due to external factors?

ii) Could the same 25-26 percent expansion rates be achieved with less volatility via a more even distribution throughout the year? And if the answer is affirmative, here is the more crucial by-product question: How would macro and banking sector performances be affected by this hypothetical alternative state of the world?

The latter one of the above questions, we believe, is by no means trivial and it deserves some thorough inquisition even if no definitive answer is available.

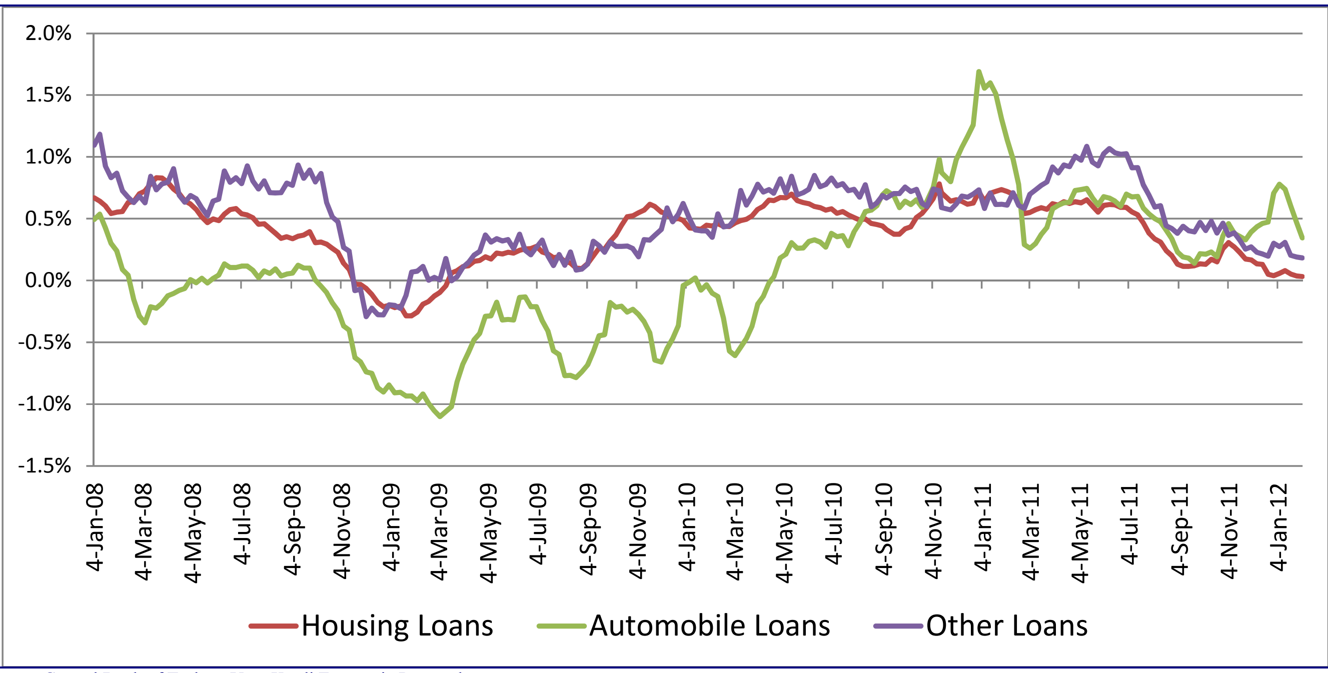
Corporate loans finally registered an increase in volume outstanding following three consecutive weeks of reduction. They also happen to border the 25% target at the moment after having hovered around 40 percent levels in October 2011.

Consumer/Commercial Credits - Levels



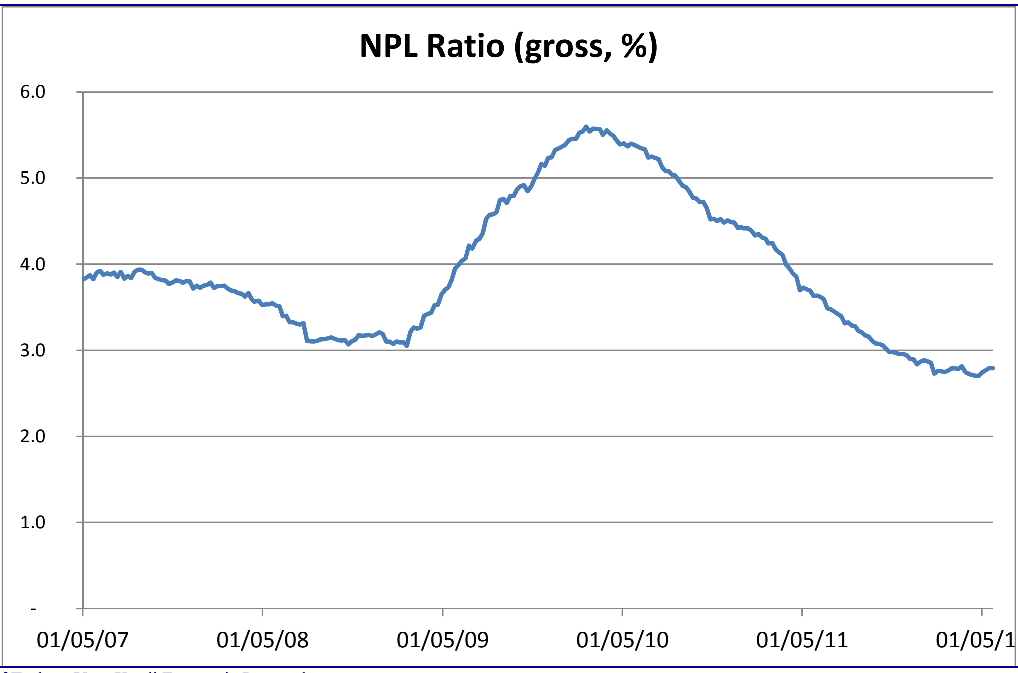
Source: Central Bank of Turkey, Yapı Kredi Economic Research

Consumer Credit Volume (*)



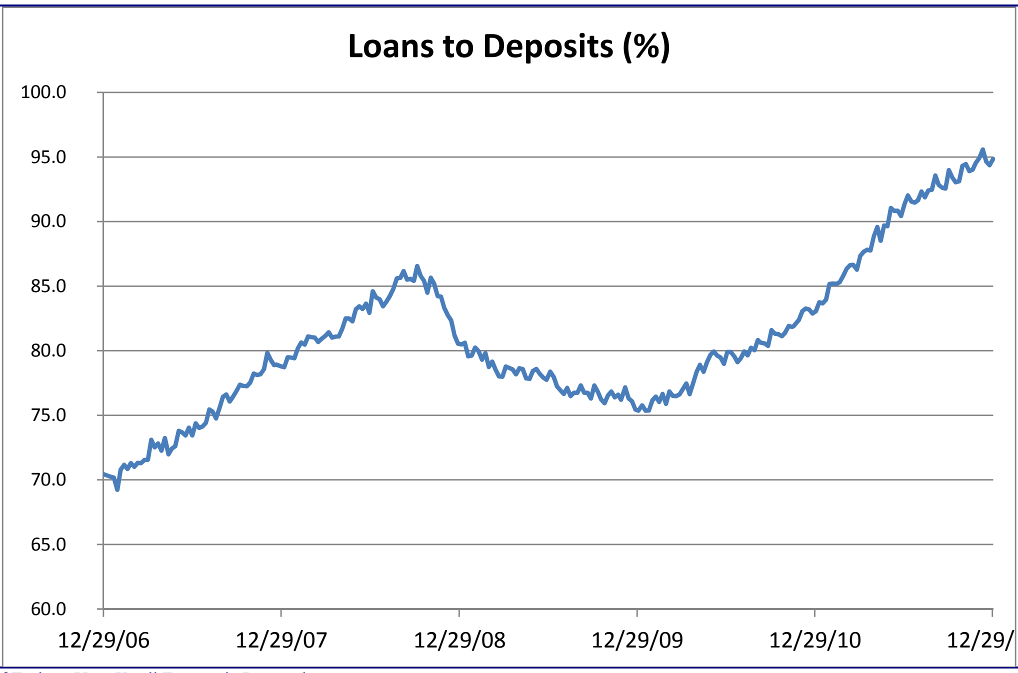
Source: Central Bank of Turkey, Yapı Kredi Economic Research
(*)Weekly % change of 8W average

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

Reflation, Normal, Crack-Up Boom, Stagflation

"I start from the presumption that we want macroeconomics to account for the occasional aggregative pathologies that beset modern capitalist economies, like recessions, intervals of stagnation, inflation, stagflation, not to mention negative pathologies like unusually good times. A model that rules out pathologies by definition is unlikely to help."
Robert Solow, 2003

"If the credit expansion is not stopped in time, the boom turns into the crack-up boom; the flight into real values begins, and the whole monetary system founders."
Ludwig von Mises, Human Action, 1949

In their fear to prevent deflation and 1930s type Great Depressions, the global central banks' new pre emptive and super active attitude could prove to be detrimental to economies in the form of lower growth, higher and sticky cost inflation and inflation expectations.

There are still many (including the IMF) that warn that the world might risk sliding into a 1930s-style slump, such as the Great Depression and they may be right. However, while economists are still debating what caused the Great Depression what we need to remember is that the gold-exchange-standard was in place in many countries in that episode, which was characterized by worldwide defaulting banks and a shrinking of the money supply, which in turn led to falling prices across the board (deflation), sharply falling production and drastically rising unemployment.

However, today's circumstances (fiat-money regimes, debt levels, active central banks, geopolitical risks) are probably more similar to the 1970s. When the then (1970s) popular economic thinking (Keynesian without actually representing Keynes' original thoughts), ultimately couldn't explain stagflation, Milton Friedman argued that stagflation was caused by excessive government spending funded by new money creation and a new consensus (which was actually similar to the old consensus prior to the 1920-1930s) emerged, a consensus which has been dominant and influential ever since.

Thus, in "fighting" and making sure deflation does not happen, following the 2008 crisis, global central banks have been increasing their balance sheets and commercial banks' (excess) reserves drastically. As banks in “developed” markets are not using these funds completely to extent additional credit (partly due to high private debt levels) money has been largely bypassing the real economies of these countries and flowing somewhere else, including growth assets/economies like Apple shares as well as oil, gold and EM, thereby stimulation the latter’s credit dynamics.

The way monetary reflation works has probably not changed, but initial conditions and transmission channels may have, and so our understanding of how it works and what unintended consequences may result may be incomplete if only guided by recent history.

From a capital account perspective, reflationary efforts could push capital flows into higher growth economies and assets and many seem to think that circumstances are very similar to 2009 or even 2010. However, this time around, the starting conditions (i.e. growth, inflation levels, credit cycles, public and private debt levels) are quite different and the economies’ reaction would be ambivalent at best.

In 2009 and even 2010, capital inflows were (seen as) a positive development since they provided much needed stimulus to EM. However, this time further reflation by global central banks could create three kinds of problems.

1) currency appreciation and its implications for the current account

2) resistance to currency appreciation and reacting with ‘implicit’ easing may push capital into the real economy and further raise credit growth, which could worsen the balance sheets of the non-financial as well as have implications for the current account

3) rising commodity prices leading to a stagflationary impulse

While the CPI inflation outlook remains relatively benign and it looks as if several countries are starting to see improving growth as well as inflation prospects the risks of stagflation may be more subtle. Global central banks may not fully recognize that reflation is a blunt instrument, and that large quantities of excess liquidity can find its way into assets that can work against the intended wishes.

For instance, monetary reflation by global central banks, decent growth, weather conditions and political risk in a number of oil-producing countries as already started to effect oil prices and North Sea Brent crude was up nearly 5% just in January. The the price of crude oil has rebounded by $20 /barrel since its October low, after averaging $110 /barrel last year despite the fact that OPEC total output of oil has reached 31-million barrels per day (bpd), up from as low as 28.5-million bpd in 1Q 2011.

The impacts of oil price changes (these apply not only to oil but other commodities as well), which are typically referred to as "oil shocks" on economic activity and inflation are hard to quantify and predict. However, broadly speaking the assumption backed by data is that a) if an unexpected increase in prices is driven by an unexpected boom in world economic growth (a demand shock), prices and growth could move upward together, at least in the short-term. Thus, higher oil prices act as a drag on the economic growth but are unlikely to cause a downturn on their own. On the other hand, b) if oil shocks are due to an unexpected and sudden disruption in oil output caused by events (supply shocks) these are likely to elevate oil prices irrespective of global demand conditions and could trigger recessions.

However, what if there is option c)? What if commodity/oil prices have become extremely sensitive to global central banks' policy reflation, more so than actual real demand and supply conditions? What if the current rise is not only due to perceived supply risk and is partly a result of monetary policy? What if oil is now an endogenous (dependent) variable in monetary policy, a policy which is unlikely to change for quite a long time? What if the 2008 crisis was in part triggered by this relation/dynamic between monetary policy and commodity prices?

One must follow this reasoning through to the prognosis that that the current reflationary episode will have shorter life span, be more problematic, will have greater unintended consequences and deliver less short-term growth at a higher cost in cost price inflation. Please remember, too, that such a stagflationary impulses could create shorter cycles, a lower mean for growth and higher volatility and create many mini short-lived bull and bear markets.

Most simply put, our analysis suggests that, while the continuation of the current/normal state of affairs or a crack up boom are possible, a shift to a stagflationary environment from a reflationary ("The Return of the Carry Trade") one has become more likely. While, global central banks' reflation (including of the ECB through its LTRO) are widely seen as "game changers", we suspect that these could drivers of stagflation. As far as we are aware of this possibility is not talked about or priced in (except in a few assets) at all. At some point, this backdrop is likely to create the potential for some "Greatest Trade Ever" type trade set ups.

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