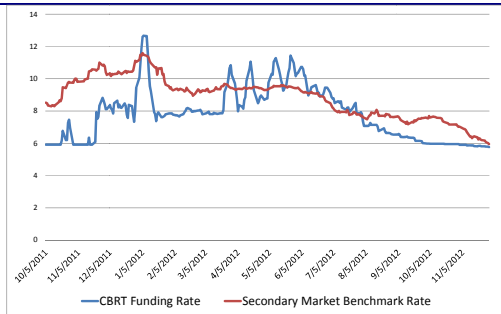


Turkey Weekly Macro Comment

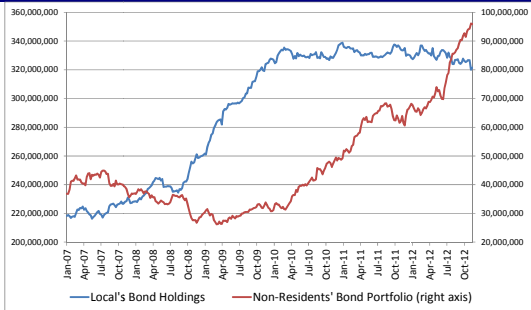
03 December 2012

Bond Rates vs CBRT Funding Rate



Source: Central Bank of Turkey

Domestic & Foreign Bond Portfolios



Source: Central Bank of Turkey

Better than Expected,,,

- This has been the motto of markets for the last few working days when some crucial data were announced including today's inflation figures (foreign trade data being the other one from last week).
- Both data sets need to be interpreted with caution and the distinction between transitory vs. permanent factors responsible for improvement has to be made delicately and preferably with caution.
- Neither infamous gold exports nor the slowdown in the economy are enough, even together, to explain the huge gap between market expectations and realizations on foreign trade front for the latter part of the year in particular.
- Even given these better than expected data realizations on the two most important fronts, we believe the CBRT will refrain from a gong ho "more cuts to come, and everywhere; in the policy rate, at both ends of the corridor, you name it" mode for myriad reasons.

Cevdet Akçay

Chief Economist, Yapı Kredi Bank & Yapı Kredi Yatırım

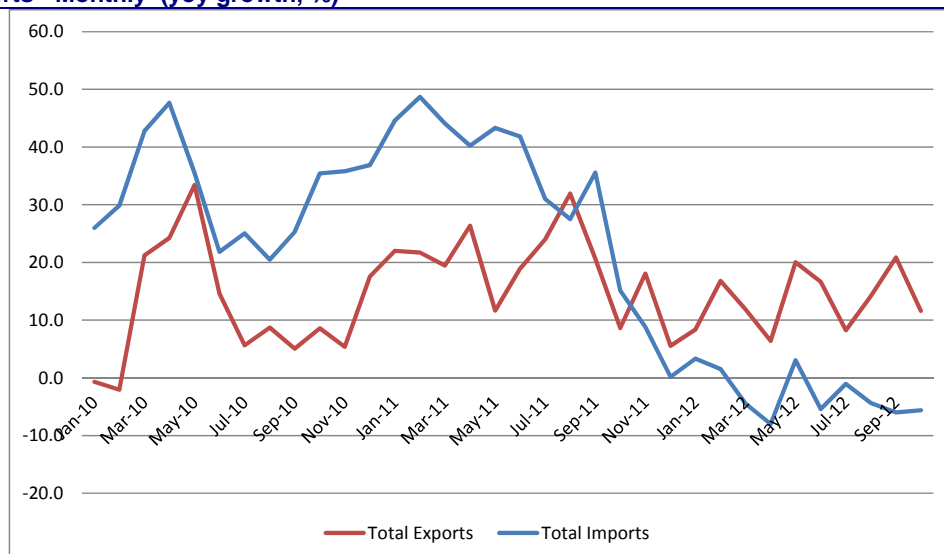
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Better than Expected,,,

This has been the motto of markets for the last few working days when some crucial data were announced including today's inflation figures. First, trade deficit for the month of October at USD 5.5 billion came in way below the market expectation of USD 8.2 billion. Then, today's inflation announcement of 0.38% for the month of November also turned out to be significantly lower than market expectation at 0.9%. There are plausible explanations for both "misses" on the part of the market but let us state at the outset that infamous gold exports are not the culprit in the former.

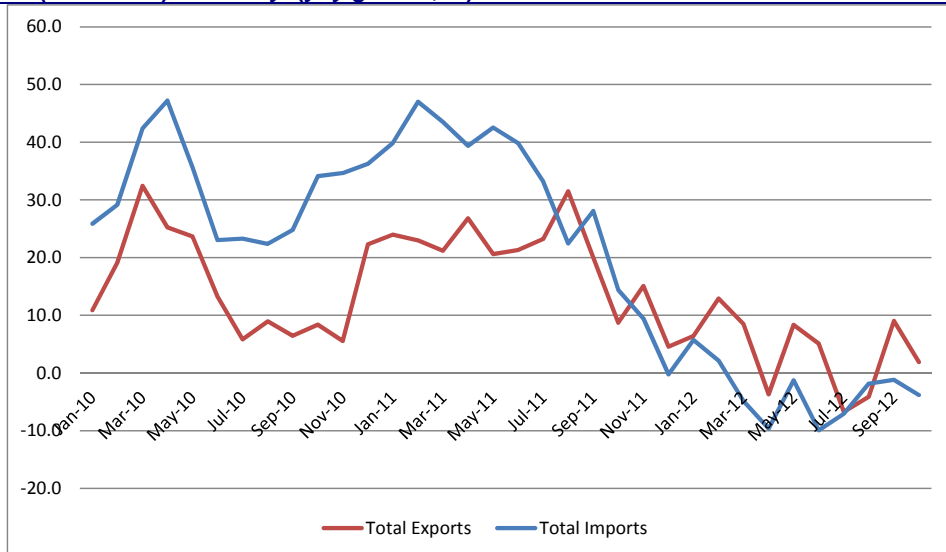
Markets seem to have been overwhelmingly taken aback by lower than anticipated foreign trade and current account deficit numbers for almost the entire 2012. The latest trade deficit figure of USD 5.5 billion vs. the market expectation at USD 8.2 billion is a fresh testimony to that fact. A miss of this magnitude cannot be attributed to infamous gold exports which at USD 1.244 billion was the lowest in the last seven months. It is the reduction in imports that has been missed big time it seems. And clearly, the main drivers behind imports are, generically speaking, growth and real exchange rate movements. We will display a very rudimentary approach in our investigation into what the sources of this and previous big misses in trade (current account) deficits may be. Take a look at the YoY changes in exports and imports on a monthly basis in total and in excluding gold categories given below.

Imports and Exports - Monthly (yoy growth, %)



Source: TURKSTAT

Imports and Exports (excl. Gold) - Monthly (yoy growth, %)



Source: TURKSTAT

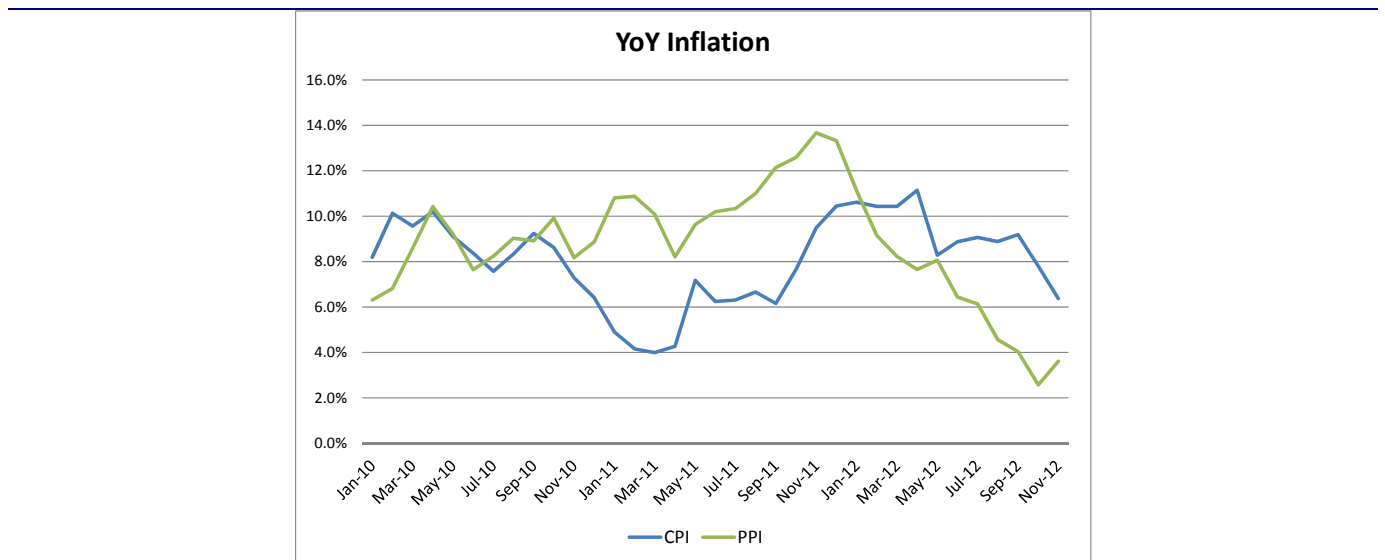
It is clear in both total and ex-gold pictures that rate of growth of exports moves above that of imports as of November 2011 and has stayed above since then. That is the source of correction in the deficit and while gold exports have emerged as a contributor since April 2012, it is the reduction in imports that has been catching market analysts by surprise most of the time. When the two jointly contribute to the closing of the deficit and the reduction in deficit moves beyond market's expectations, gold exports serve as the culprit for the miss and the reduction in imports is overlooked. More interestingly, economic growth is very much in line with expectations and is even higher than some conservative estimates and cannot thus serve as an explanation for the import figures pleasantly surprising market analysts on a steady basis. One plausible explanation can be that the exchange rate component in this reduction has been underestimated or miscalculated particularly with respect to the time lag with which a real exchange rate shock displays its impact on imports. We had opined a year ago that the lag structure seemed to have changed drastically in favor of longer lags where we would be seeing the bulk of the impact on imports with lags significantly longer than those observed before.¹ Many market participants were expecting falls in imports volumes in a short time following the risk-off mode reign and the sell-off in emerging markets which led to Lira

¹ http://www.yapikredi.com.tr/en-US/macroeconomic_research/pdf/occasional_macronotes/The%20Time-Varying%20Sensitivity%20of%20Imports%20to%20Production%20and%20Real%20Exchange%20Rate%20Shocks_%2022%20Aug%202011.pdf

depreciation last fall. We were of the opinion that the soft landing process would be reducing import growth somewhat but that the bulk of the correction would be coming later on in 2012 when soft-landing would be accompanied by the real exchange rate impact on imports. That looks like what has been taking place within the last six or seven months.

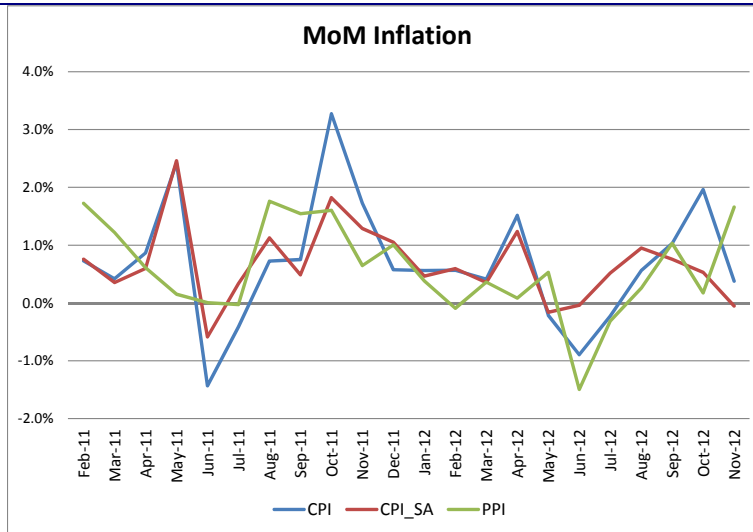
Inflation also turned out to be much better than expected for the month of November at 0.38% vs. the market expectation of 0.9%. With the exception of clothing and shoes inflation at 6.3% which is the only noteworthy monthly inflation figure, all of the remaining categories' inflation are all quite benign (4 out of the other 11 categories indeed had negative inflation showings for the month). Food inflation, the colossal and unpredictable category, registering a minus 0.12 percent for the month was naturally the big contributor to low headline figure. PPI at 1.7% is quite sizeable and may have a pass-through impact on forthcoming CPI figures the significance of which is to move in tandem with the pace of economic activity.

YoY Inflation



Source: TURKSTAT

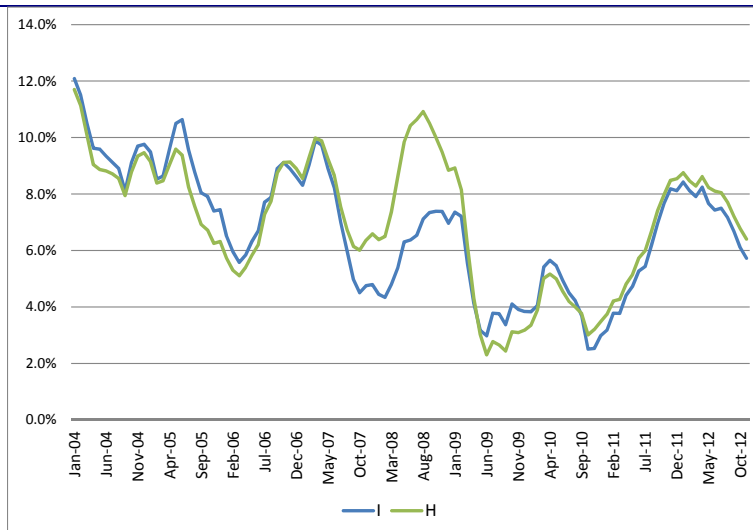
MoM Inflation



Source: TURKSTAT

Special consumption indices also turned out to be quite promising as CBRT’s most favored indices H and I continued to sail south. Index I indeed moved in 5% category which, if sustained, will prove to be very supportive of the disinflation process.

H and I Indices



Source: TURKSTAT

Regardless of growth outlook, there is a mental threshold at 5% for threshold inflation in Turkey. The longer we linger around in the 5% territory, the less will become the resistance

for 5 and below inflation levels. We believe it is doable, and we continue to claim that inherent dynamics of inflation is definitely and significantly more benign than the perception of the average citizen. We also believe that the inherent dynamics is discernibly better than the perception of the representative market analyst as well. This was a strong inference that we came up with in a research we had done in the beginning of last year and we do not expect any changes when we update it soon.² Inertial inflation is presumably coming down albeit at a slower pace which is only natural given the single digit levels we have been enjoying for some time. Barring exogenous shocks the impact of which dissipate over time and vanish after a while if expectations are not harmed in any permanent sense, the capacity of the price system to “replicate itself” (and hence converge to zero inflation) was found to be increasing over time in our research. The reduction in inertial inflation and this capacity increase happening jointly (time varying parameters approaching 0 and 1, respectively) is the key to secular disinflation. The duo may not have performed much better but there is no reason to assume that they have been performing any more poorly compared to the end of our sample period which was September 2010.

That said, a few words about the “more cuts to come, and everywhere, in the policy rate, at both ends of the corridor, you name it” mode that is rampant in the market. We believe the CBRT will refrain from a gong ho mode for myriad reasons. The much feared unstoppable inflows following investment grade has not taken place yet. Moreover, it is questionable as to whether inflows that will render the CBRT desperate with respect to strong TL appreciation are anywhere in sight. Given all the “better than expected” news piling up lately, currency basket is still slightly above 2.05 presumably as a result of the success of the moral suasion policy adopted by the CBRT³. Is there any reason at the moment to act preemptively and discourage all those imminent colossal inflows assumed to be waiting at the gate? We think not. We also believe that the CBRT is aware of the slow change taking place in the composition of output, i.e. domestic demand slowly picking up and exports maintaining their composure yet naturally losing weight in overall output. However, commercial loan performance was more erratic and entailed a weaker trend compared to consumer loans until very recently (except the last data week, to be precise, which is of little essence as a single

²

http://www.yapikredi.com.tr/en-US/macroeconomic_research/pdf/occasional_macronotes/Inference%20Should%20Not%20Be%20in%20the%20Eye%20of%20the%20Beholder%2017%20Feb%202011.pdf

³ We mentioned one handicap pertaining to that policy which was mainly the use of an inappropriate tool (the real exchange rate index) to serve the trade-off between the efficacy of the rhetoric applied and the appropriateness of the tool selected for the purpose.

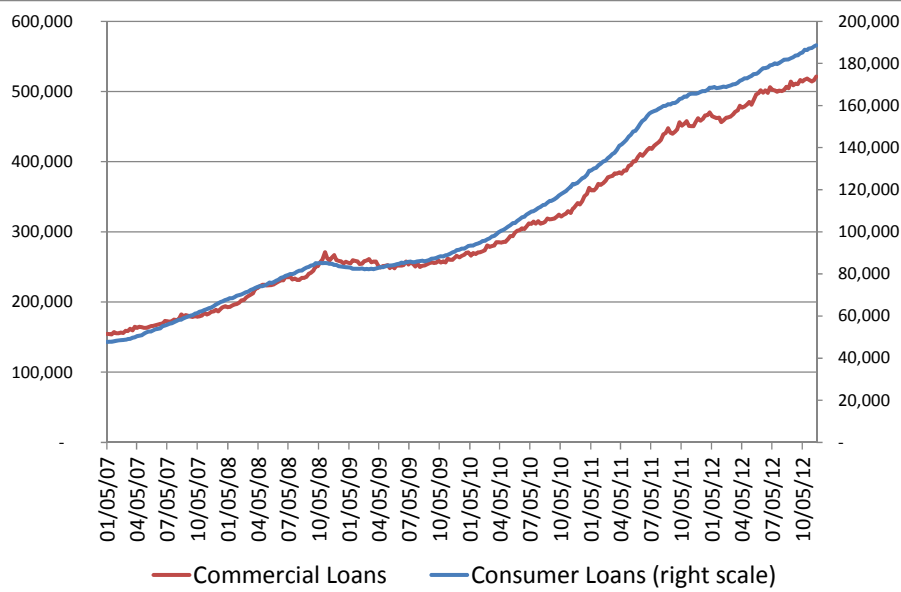
data point) as we highlighted in our earlier weeklies. That could (should) be a source of concern for the CBRT as further loosening that creates additional impetus for consumer loans while leaving commercial loan performance more or less intact would be totally undesirable from a central bank standpoint.

Thus, whether this most recent strong commercial loan showing (for one week!) is yet another freak case in the extremely erratic commercial loan realm of Turkey during times of economic slowdown or whether it is the beginning of a rejuvenation following the loosening by the CBRT (funding rates currently at an all-time low of 5.61%) is yet to be seen. If it is the former, then the weak trend in commercial loans and the relatively stronger trend in consumer loans should be acting as a deterrent for further loosening as that composition is not conducive to cuts for a central bank that is still focused on disinflation. If it is the latter, then why go for loosening as economic activity in that case will only gain further momentum hence requiring no additional impetus from the Bank? The only other option to justify further loosening would be the low risk attached to “overdoing” loosening but we have a hard time quantifying that low risk and would opt for giving policy enough time to display its impact on economic variables of interest rather than “guaranteeing” the desired action in those variables via overdoing.

Weekly Data (all weekly data terminate on November 16, 2012 while consumer credits are one extra week updated)

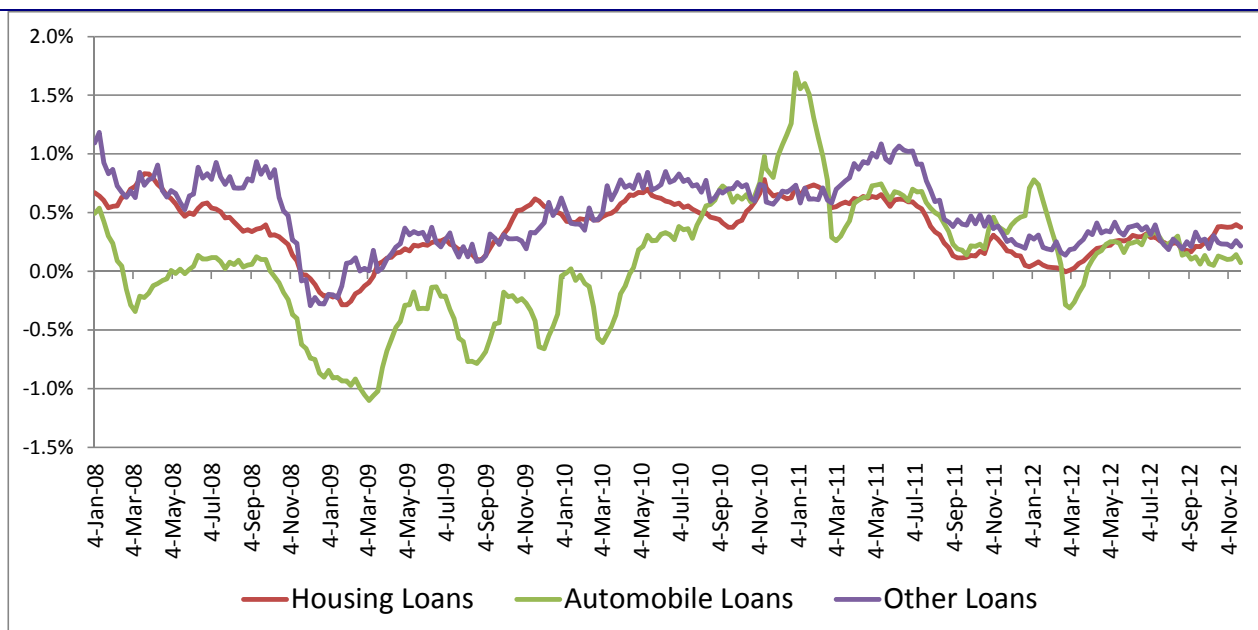
The only eye-catching development on weekly data front was the substantial increase in commercial loans by TL 5.2 billion in the week of November 16. Of the last 12 data points starting with August 31, 5 weeks’ data registered reductions in total loan volumes, average weekly change turned out to be TL 1.4 billion with a standard deviation of TL 4.1 billion! One would be better off not betting on anything in this category before the bigger picture reveals an unequivocal trend formation whereby the irregular component that currently constitutes the bulk evaporates and is replaced by a strengthening cyclical and/or trend component.

Consumer/Commercial Credits – Levels



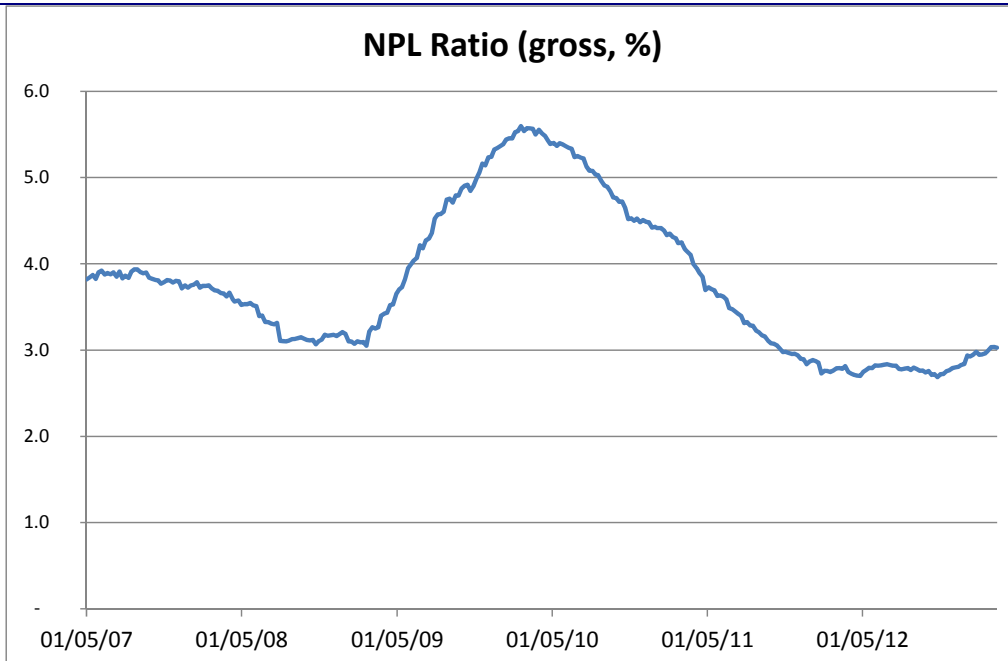
Source: Central Bank of Turkey

Consumer Credit Volume (*)



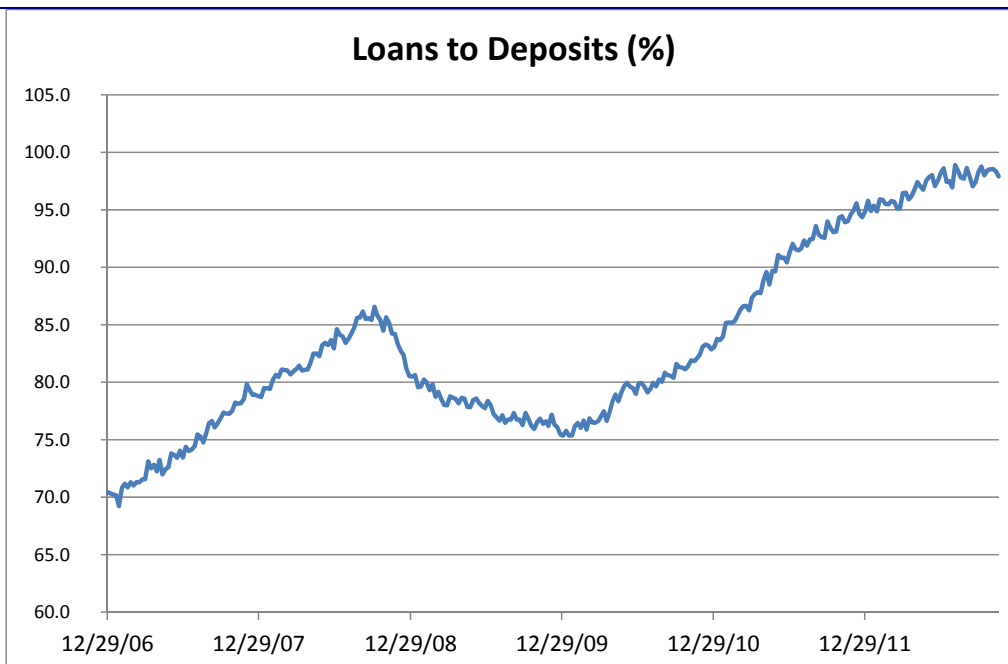
Source: Central Bank of Turkey, Analytical Modeling and Macroeconomic Research
 (*) Weekly % change of 8W average

NPL



Source: Central Bank of Turkey

Credit/Deposits Ratio



Source: Central Bank of Turkey

Markets

by Murat Berk / Economist and Investment Strategist

Stabilization, Carry Trades, “Reversal of the Reversal” Complete?

“...consequences of policies aimed at lowering the rate of interest and at encouraging business activities through credit expansion gave birth to the ideas which finally generated the slogan "stabilization." One can explain its emergence and its popular appeal, one can understand it as the fruit of the last hundred and fifty years' history of currency and banking, one can, as it were, plead extenuating circumstances for the error involved. But no such sympathetic appreciation can render its fallacies any more tenable. Stability, the establishment of which the program of stabilization aims at, is an empty and contradictory notion. The urge toward action, i.e., improvement of the conditions of life, is inborn in man. Man himself changes from moment to moment and his valuations, volitions, and acts change with him. In the realm of action there is nothing perpetual but change. There is no fixed point in this ceaseless fluctuation other than the eternal aprioristic categories of action. It is vain to sever valuation and action from man's unsteadiness and the changeability of his conduct and to argue as if there were in the universe eternal values independent of human value judgments and suitable to serve as a yardstick for the appraisal of real action.”

Ludwig von Mises, Human Action, 1949

Money continue to flow going into high grade, low grade/high yield and EM alike. I think bull markets in debt are actually less exciting than bull markets in stocks, because in debt, there are usually some mathematical boundaries. Whereas with stocks, they really can go to infinity on the back of a good story, or at least that's what people thought about the Nasdaq in 2000.

That said as long as we the chase for yield continues, high yield and EM will do okay benefitting from leverage and short memories, and where once again investors have chased yields into negative territory, which has been boosting equities.

In a sense, things are different this time is because central banks around the world seem determined to have negative real policy rates for many many years ahead. Obviously, policy rates influence market rates but these are not the sole determinant. More specifically, valuations and the economic variables (e.g. default rates for HY) still matter. The biggest risk to the current benign appearing low volatility, search for yield goldilocks environment are: 1) a recession 2) inflation. For what's worth, my view remains that policymakers will continue to run loose policies as long as the market backdrop is conducive and this is likely to result in stagflationary impulses. During the stagflationary 1970s, volatility increased and there were many mini bull/bear cycles but major stock markets did not perform well despite the now popular notion, that stock prices will rise in tandem with a benign increase in inflation.

Anyway, the more immediate questions now are how much more room is there for yields to go further negative? How sustainable would that be? What would be the side effects on the balance sheets as well as the economic structure? Given the strong momentum and the CBRT's new focus on REER, the perception is that we have entered a new virtuous cycle where inflows attracted by fundamentals, carry and strong performance lead to a stronger currency, which leads to further easing expectations, which leads to a rally in bonds and equities, which further drives in momentum and trend following inflows...

In fixed income the main drivers of total returns are carry and spot FX for local currency debt and the bond price (duration). Here the FX component has become quite tricky. The CBRT, rightly or wrongly, has created the perception that it will not tolerate a real appreciation of TRY. Also by refraining to comment on the REER levels the Bank would feel uncomfortable on the weak side, the Bank might create the perception that it sees things seeks nominal depreciation creating an asymmetric pay off profile. As said before, this isn't much of a problem when inflows are strong but when/if these stall then local bonds may appear less attractive to foreign investors (other things being equal) due to the perception of an asymmetric pay off profile for the TRY.

As it pertains to credit, the simplest form of the carry trade is borrowing short and lending long. Well, there is a carry trade in equity volatility, too, or that's what people seem to be thinking. That's when you "ride down" the term structure in volatility or you "just collect" the premiums (like clipping dividend coupons!) by being short Gamma.

However especially nowadays, my guess is that the system’s leverage could be higher, because there isn’t much carry to be earned. I again guess that very crowded and vulnerable positions among “EM tourist investors” could be out there. In any case, the risk/reward ratio has become much more asymmetric.

As an aside, market participants seem to be focusing (wrongly) on the risks in the public sector. By contrast, I continue to believe that unlike in the past the risks are to be found in the private sector on the back of the boom in credit growth and real estate supply.

Although my market model remains neutral, equities appear to be completing their “reversal of the reversal” and the levels of valuation, volatility and yields suggest that equities (and gold) could come under selling pressure until January 2013.

ISE 100 (purple), benchmark bond yield (red), UBS carry trade index (green) USD/TRY 1 month option volatility (white), 2007 to date



Source: Bloomberg

Benchmark bond yield (red), CS CIRVE index (white) 2007 to date



Source: Bloomberg

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