November Inflation …

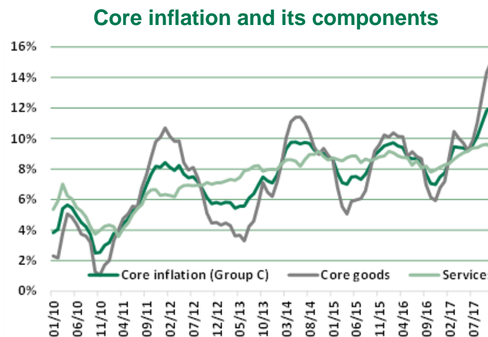
November CPI inflation at 1.49% was close to our 1.40% expectation, but turned out to be above the 1.17% average market expectation (Reuters survey). This brought annual inflation to 13.0% from 11.9%. D-PPI inflation was 2.02% while the annual change remained flat at 17.3%.

CPI inflation reached all time high sin November ince the inception of 2003 series

- Food inflation at 2.1% was high as in October, and may be deemed the major factor behind the higher than expected CPI print. Annual food inflation edged up to 15.8% from 12.7% a month ago. Note that food inflation was at 5.6% at end-2016, making a significant contribution to inflation in 2017.
- Core inflation (group C) continued to climb to 12.1% from 11.8%. This increase seems to have been caused by core goods inflation (i.e. fx pass-through from weaker TRY), which reached 15.0% on an annual basis from 14.3% in October (and 6.8% at end-2016.). Meanwhile, the service inflation component eased slightly by 0.3% from 9.6% and 9.4%. Nevertheless, this is still way above comfort levels, and indicates rigidity in pricing behavior.
- High energy prices (both the result of weak TRY and spike in oil prices) were another major factor pressuring inflation. Energy inflation was 2.5% and made roughly a 0.35% contribution to November CPI inflation.

We now believe that CPI inflation may remain (around 10% in Q18, exceeding the market's initial 8.0-8.5% expectation

We, as all market participants, expect a decline in CPI inflation in the coming months, due to the favorable base effect. Nevertheless, our end-2017 CPI inflation estimate is 11.5%, which is way above the CBT's 9.8% estimate (revised in early November from 8.7%). With the above-expected inflation prints of recent months and sharp TRY depreciation, the expected Q1 decline in inflation is also likely to be slower than initial expectations. We now believe that CPI inflation may remain at (or very close to) the double-digit trajectory (around 10%) in Q118, exceeding the market's initial 8.0-8.5% expectation.



Source: TURKSTAT

October balance of payments…

October's C/A deficit came in at USD3.8bn, below the USD4.1bn market expectation and our USD4.2bn estimate. The 12-month rolling deficit rose to USD41.8bn from USD39.6bn in September. This rise is attributable to the surge in imports (up 25% y-o-y in September), while net tourism revenues, rising 30% y-o-y, continued their positive impact.

Private sector borrowing intensified in October

The private sector's intensified borrowing (eurobond issuances and loans from abroad) in October more than covered the C/A deficit. In detail, banks' and corporates' rollover ratios (for long-term loans) were at 137% and 161% in October, respectively. They also increased their net short-term loans. As a result, private sector's net loans rose by USD4.0bn, of which USD2.4bn came from the banking sector and USD1.6bn from the corporate sector.

C/A deficit was largely financed by portfolio inflows Ytd

They also issued USD1.7bn worth of eurobonds (USD0.7bn from banks and USD1.0bn from corporates) bringing the private sector's total borrowing in October to USD5.7b, which more than covered the USD3.8bn C/A deficit.

There were also USD3.8bn of unregistered inflows (net errors and omissions) in October. This played an important role behind the USD5.0bn increase in official reserves (together with intensified borrowing). On the other hand, inflows into TRY government bonds and equities were at a mere USD0.1bn each and net FDI inflow was just USD0.6bn.

For the January-October period, capital inflows reached USD37.1bn vs. the USD35.3bn C/A deficit.

With the addition of USD2.7bn net errors and omissions, official reserves rose by USD4.5bn Ytd.

C/A deficit was largely financed by portfolio inflows between January and October, which reached USD24.4bn (including Treasury's and private sector's eurobond issuances). In detail, inflows into equities and local bonds were registered at USD3.1bn and USD7.6bn, while the Treasury issued net USD5.3bn worth of Eurobonds.

The private sector's borrowing capacity from international markets will be critical going forward for sustained growth…

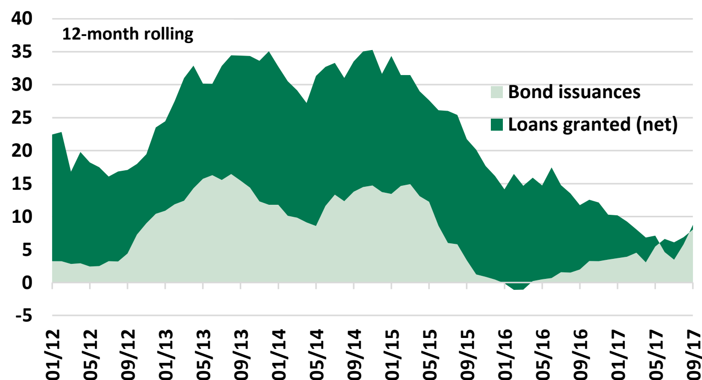
Private sector's eurobond issuances gained steam this year by reaching USD8.9bn Ytd compared to USD3.6bn in the same period of 2016. On the other hand, loans granted from abroad was registered at a mere USD3.9bn compared to last year's already weak USD7.6bn figure. As a result, private sector's total borrowing was USD12.4bn in the January-October period, compared to USD11.1bn in the same period of 2016.

Despite the private sector's intensified borrowing in October, total borrowing has in fact contracted sharply over the past two years. Specifically, its total borrowing on a 12-month rolling basis rose to USD11.6bn in October from USD8.9bn in September. Nevertheless, this remains well below the USD30-35bn levels registered between 2013 and 2015.

Borrowing capacity from abroad critical for sustained growth. With the loan to deposit ratio at above 125%, together with the Treasury's rising borrowing requirement, the private sector's borrowing capacity from international markets will be critical going forward for sustained growth, which was fueled by the Credit Guarantee Fund in 2017.

With preliminary foreign trade data (released by the Undersecretariat of Customs), we expect a USD3.8-3.9bn C/A deficit in November, which would bring 12-month rolling C/A deficit to roughly USD43.5bn. It is likely to reach USD44-45bn by end-2017, which is 5.3% of GDP.

Private sector's total international borrowing



Source: CBT, Şeker Invest

Monetary policy review…

The magnitude of the rate hike was less than the wider market expectation of a 100bps hike in the LLW rate

At its long awaited MPC meeting on 14 Dec, the CBT hiked only the late liquidity window (LLW) rate by 50 bps, which is below market expectations. Accordingly, the LLW rate increased to 12.75% from 12.25%, while the O/N lending and weekly repo rates remained stable at 9.25% and 8.0%, respectively.

The CBT's decision was far from the wider market expectation of a 100 bps LLW rate hike, and even failed to satisfy the most dovish expectation of the market survey, which was for a 75bps hike in the LLW rate. Our expectation, on the other hand, was for a combined 75-100 bps hike for both the LLW rate and the O/N rate.

Following an initial negative reaction, currency and rates improved due to upbeat global sentiment and lifting of US visa ban

Following the CBT's decision, although there was an initial negative reaction in currency and rates (as the USD/TRY mounted to 3.88 from 3.82 and the 10-year bond yield also rose to 12.36% from 12.12%), we had stated our expectation that we might retreat to previous price levels, observed before the meeting, due to upbeat global sentiment. This expectation turned out to be true as USD/TRY fell to 3.76 and 10 year bond yield fell as low as 11.64% (as of 02 Jan), with positive global sentiment and the lifting of the US visa ban, later on.

We think that global sentiment will continue to be the determining factor for the evolution of rates and currency going forward, With a mere 50 bps hike, the CBT will have little or no monetary policy flexibility (to increase the average funding rate) in case of a reversal in market sentiment. Therefore, we also believe that there is a considerable likelihood that the CBT might be forced to continue rate hikes at upcoming MPC meetings.

3Q17 GDP growth

TURKSTAT reveals 3Q17 GDP growth of 11.1% YoY, vs. our 10.5% estimate and the 8.7% market expectation. Working-day adjusted GDP growth was at 9.6% YoY. The working-day and seasonally-adjusted GDP series pointed to 1.2% growth on top of respective 1.6% and 2.2% growth rates in 1Q and 2Q. TURKSTAT also revised 1Q and 2Q GDP YoY growth figures to 5.3% and 5.4% from 5.1% and 5.2%, respectively. Cumulative (9M) GDP growth in 2017 reached 7.4% YoY.

Strong GDP is purely explained by (private sector driven) domestic demand growth

Strong 3Q GDP growth stems completely from domestic demand (led by the private sector), as the contribution from domestic demand is 10.9%, while net exports made only a 0.2% contribution.

The YoY growth in durable goods consumption was a striking 31.1%, which clearly reflects the positive impact of the Credit Guarantee Fund (CGF) and the temporary tax cuts in white goods and furniture. Total private consumption growth was 11.7%, which accounts for 7.0% of overall 11.1% GDP growth. Public consumption growth was 2.8%, suggesting a mere 0.3% contribution to GDP growth.

There has also been a revival in total investments with 12.4% YoY growth, making for a 3.6% contribution to the GDP growth. Note that over the past few quarters, investment growth had purely been based on construction, while machinery-equipment investments in fact contracted. Nevertheless, investment growth in 3Q is also spread to machinery and equipment investments, which registered 15.3% YoY GDP growth.

The production side reveals that growth was widespread, with YoY growth in industry, construction and services (domestic trade, transportation and tourism combined) sectors reaching 14.8%, 18.7% and 20.7%, respectively. Growth in the agriculture and other services (combined) sectors was at a respective 2.8% and 5.4%.

2017 GDP growth might reach close to 7.0%

Prior to the release of the 3Q GDP data, our 2017 GDP growth estimate was 6.7% (above the 5.5-6.0% market expectation), even though we expect a slowdown in QoQ growth in 4Q17 to the 0.0-0.5 range. As 3Q GDP growth slightly exceeded our expectation and 1Q and 2Q GDP growth figures were also revised upwards, there might even be an upside risk to our prior estimate, whereby 2017 GDP growth could approach 7.0%.

Why we expect 2018 GDP growth to slow down to 3.0-3.5%?

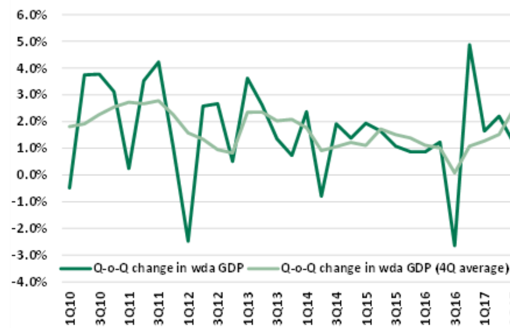
We expect 2018 GDP Wrowth to slow down to 3.0-3.5%

We may extend our predictions through the end of 2018 using our QoQ growth assumptions. Note that, the average QoQ growth stands at 1.5% year-to-date. Historical GDP data also suggests that average QoQ growth was 1.6% since 1Q10 and 1.5% since 1Q13. We expect the average QoQ growth pace to decelerate to slightly below 1.0% in 2018. This brings our 2018 YoY GDP growth estimate to 3.0-3.5%.

Our slowdown expectation in the QoQ GDP growth pace in 2018 is due to the following factors:

We believe that the positive impact of the credit guarantee fund (CGF) will be much more limited in 2018, together with the fact that loan to deposit ratio is above 125% and external funding is constrained compared to the previous few years. The Treasury's rising borrowing requirement is also creating a "crowding-out effect".

QoQ GDP growth (seasonally adjusted)



Source:TURKSTAT

October IP…

The working day adjusted industrial production index rose by 7.3% YoY, vs. the 5.3% market expectation, while the un-adjusted series points to a 8.9% YoY rise, vs. the 5.4% market expectation. The seasonally adjusted series pointed to a 0.7% m-o-m increase.

The strength in industrial production seems to be widespread across almost all sectors, with half of the total 24 sub-components registering double-digit growth rates. Of these, the growth in wearing apparel of 17.0%, machinery and equipment of 19.4%, fabricated metal products of 17.9%, and motor vehicles of 12.0% is worth mentioning.

November central government budget

The central government budget posted TRY 8.5bn surplus compared to TRY10.0bn surplus in the same month of last year, while primary surplus reached TRY 13.6bn vs TRY13.9bn last year. The deterioration is more visible in the y-t-d figures, with the budget deficit surging to TRY 26.5bn from TRY 2.1bn in Nov-16, and primary surplus shrinking to TRY 28.8bn from TRY 46.3bn.

2017 budget deficit might remain below projection

There was TRY2.2bn additional revenue from tax restructuring plans in November, bringing the total restructuring revenue to TRY13.9bn Ytd and to TRY27.7bn since the beginning of the plan in Oct-16. On the expenditure side, there was a 17.3% decline in transfers to social security institutions, contrary to the 27.6% increase during Jan-Oct. This is due to the government's prior incentive to suspend firms' social security payments pertaining to Dec-16 – Feb-17 period into 4Q17.

Recall that, with the the government's mid-year revisons, the TRY46.9bn initial budget deficit projection for 2017 was revised to TRY61.7bn and the TRY10.6bn primary surplus projection was revised to a TRY4.2bn primary deficit. Based on the budget realisations for the January-November period, we see that full year tax revenues may exceed the revised projection by as high as TRY10bn. A few factors might have played role behind this outcome, such as higher than expeced tax restructuring revenues, the revival in imports in recent months, TRY depreciation leading to a rise in the TRY value of VAT from imports and finally higher inflation artificially boosting tax revenues in general.

TRY10bn excess in tax revenues might mean that 2017 budget deficit might be around TRY52bn rather than the TRY62bn projection (if expenditures remain within budget allowance limits). Nevertheless, in previous years, additional tax revenues was channelled for extra spending (thus the positive impact on budget deficit was less), which might be the case this year as well. As a result, 2017 budget deficit might be somewhere between TRY52-62bn.

November foreign trade

The sharp increase in foreign trade deficit continues due to intermediate goods imports

In November, exports rose 11.3% YoY to USD14.2bn, while imports were up 23.1% to USD20.5bn, bringing the foreign trade deficit to USD6.3bn (USD4.1bn in Oct-16). As a result, the 12-month rolling foreign trade deficit rose to USD73.1bn from USD71.0bn in October (USD55.8bn in Dec-2016).

The y-t-d rise in foreign trade deficit is mostly due to gold and oil imports. Specifically, USD11.3bn of the deterioration comes from the gold trade balance alone, while USD8bn comes from oil. Excluding oil and gold, the foreign trade deficit in fact fell to USD30.8bn from USD 32.7bn at end-2016.

Apart from the net oil and net gold bill, non oil and gold intermediate goods had also been

Structural reforms are required to fix the import dependancy of the Turkish manufacturing sector…

contributing significanly to the rise in foreign trade deficit over the past few months, which remained intact in November as well with a 22% y-o-y rise. Note that the core intermediate goods imports rose about 37% YoY between July and November, while capital and consumption goods imports remained relatively much weaker, rising just 6%. We attribute the recent revival in core intermediate goods imports to firms' inventory pile-up efforts, and thus may see some moderation on this front over the coming months. On the other hand, we must note that the revival in intermediate goods imports reflects the import dependency of the Turkish manufacturing sector and exports, which has been the economy's long-standing structural problem.

With the foreign trade data at hand, the Oct C/A deficit is likely to be around USD3.9-4.0bn, which will bring the 12-month rolling deficit close to USD43.5bn from USD42bn in September.

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