Macro Note – MPC preview

Which alternative will the CBT pick among numerous scenarios?

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With the TRY mounting from 3.40 in early September to above 3.80 in just two months' time span and CPI inflation climbing to 13.0%, the market is now eagerly awaiting the outcome of 2017's last MPC meeting to be held on 14 December.

The expectation set for tomorrow's MPC is widespread, with the only common thing being that all participants expect a hike in the LLW rate, but no hike in the weekly repo rate

There was a similar situation before the year's first MPC meeting on 24 Jan, as the TRY had mounted to 3.90 from around 3.00 levels in just about three months. Recall that, in the early days of 2017, just before the year's first MPC meeting, the CBT had adopted a new monetary policy setting by abandoning the "weekly repo auctions (supposedly the policy rate)" and introducing the "late liquidity window (LLW)" as its new alternate funding instrument. The CBT hiked the LLW rate by 100 bps at that meeting (perfectly in line with market expectations) and by a further 125 bps at the next two MPC meetings (held on 17 Mar and 27 Apr). The LLW (as an alternate funding instrument) made up about 40% of the total funding in its early days, but later on converted itself into being the CBT's major funding channel by comprising 90% of the total funding from April to late November, and finally became the market's only funding alternative since then.

There is a wide range of alternatives for tomorrow's MPC outcome

The poll's most dovish expectation is a sole 75 bps hike in the LLW rate, while the most hawkish one is a 225 bps hike

With this new monetary policy setting, one can create numerous scenarios with different policy rate combinations, for the outcome of the upcoming MPC meeting. To justify this statement, in history's probably most crowded market poll (for the MPC meeting outcome) with 26 participants, the expectation set is widespread, with the only common thing being that all participants expect a hike in the LLW rate (currently the effective policy rate), but no hike in the weekly repo rate (the theoretical policy rate).

Six participants expect a "combination of both O/N lending rate and the LLW rate hikes

The poll's most dovish expectation is a sole 75 bps hike in the LLW rate, while the most hawkish one is a 225 bps hike. Six participants expect a "combination of both O/N lending rate and the LLW rate hikes, which include 50 bps in O/N + 125 bps in LLW, 75 bps in O/N + 175 bps in LLW, 100 bps in O/N + 100 bps in LLW (us included) and 175 bps in O/N + 175 bps in LLW. The widest market expectation, with 12 participants, is a 100 bps hike in the LLW rate, which is referred to as the market consensus just before the meeting.

The widest market expectation is a 100 bps hike in the LLW rate

We now aim to review these possible interest rate scenarios, with their reasoning, potential market impacts and probabilities. With that, we also aim to help our readers to shape their own expectations.

The CBT first has to decide whether to maintain its current standing, or to normalize monetary policy

First of all, the CBT has to choose one of the two following options before deciding to hike which rate, and to what extent:

a.) **Sticking to its current monetary policy standing, i.e. continuing to use the LLW rating effectively:** The CBT may opt for small-scale (gradual) rate hike(s) and, with a wait and see approach, keep the door open for further rate hikes at upcoming MPC meetings.

b.) **Normalize the monetary policy, i.e. limiting, or totally abandoning the usage of the LLW:** That requires big scale (front loaded) rate hikes in both the LLW and O/N rates. With such a monetary policy standing, the CBT would not require further rate hikes at upcoming MPC meetings and would continue to use the liquidity policy effectively to determine the average funding rate.

SCENARIO 1: 200-250 BPS HIKE IN THE LLW RATE COMBINED WITH A 300-350 BPS HIKE IN THE O/N RATE

Reasoning:

This scenario is suited for "option b" (that we mentioned above) and reflects the CBT's desire to limit or totally abandon the usage of LLW as its funding channel.

"Scenario 1" reflects the CBT's desire to significantly limit the usage of LLW as its funding channel

Channeling the total funding through the LLW is obviously not the normal way of managing the monetary policy. Although, the CBT is now funding the market with a single interest rate, the current model is definitely not what the CBT aimed to achieve with "monetary policy simplification". The CBT already stated in its "2018 monetary and exchange rate policy" document that its intention was to set the policy rate as the "weekly repo rate".

We can describe the current juncture with the "abnormal has become normal" motto. In fact, the CBT now has an opportunity to normalize its monetary policy standing, i.e. to shift its funding to its ordinary instruments, the O/N lending rate and the weekly repo rate. And the only way to do this is to bring the O/N rate to at least 12.25% (the current funding rate) with a 300 bps hike combined with a similar hike in the LLW (though it might be at a lesser magnitude) in order to maintain its flexibility to increase its average funding rate, if need be.

By keeping the weekly repo rate (the CBT's intended policy rate) stable at 8.0%, the CBT would also continue to give the message that it aims the rate hike cycle to be temporary. As such, when conditions permit (pressure on TL subsides and we see some decline in inflation), the CBT could still lower the funding rate by funding the market with a combination of the O/N lending and weekly repo rates.

Under this scenario, we think that, the CBT may set the average funding rate (at the initial stage) at around 12.50-13.00% by holding the usage of LLW close to 25%.

Potential Market Impact:

We expect the strongest (positive) market reaction in "scenario 1"

In our view, this is in fact what the CBT should do and it is the scenario, which the market would react the most positively. We also believe that, this way of hiking rates may be more effective, even with a lower funding rate than in other alternatives.

Under this scenario, we expect to witness an immediate correction in TRY and a decline in the long-end of the yield curve. Nevertheless, the evolution of the currency and rates in the aftermath of initial market reaction would still be dependent on global sentiment (e.g. monetary policy stance of FED and ECB, developments on Trump's tax plan, growth outlook in China, etc). In any case, we would not expect a sharp TRY depreciation similar to the one witnessed between September and November.

Probability:

5-10%. Although the most effective alternative in our view, we do not attach a strong probability to this scenario due to the political pressure.

SCENARIO 2: 200-250 BPS HIKE IN THE LLW RATE

Reasoning:

This scenario is suited for "option a". If the CBT prefers to continue using the LLW channel, though at a lesser extent and wants to gain some monetary policy flexibility, it may opt for this option.

In "scenario 2", we think that, the CBT may set the average funding rate at 12.75-13.00% by holding the usage of LLW around 70-80%.

The CBT may shun away from hiking the ordinary policy rates, the O/N lending rate and the weekly repo rate, with political concerns, but at the same time want to give market a strong message that it could at any time increase the average funding rate to as high as 14.75%.

Under this scenario, the CBT still gives the message that it aims the rate hike cycle to be temporary. We think that, the CBT may set the average funding rate (at the initial stage) at around 12.75-13.00% by holding the usage of LLW around 70-80%.

Market impact:

The market reaction would also be very positive, though slightly less so compared to the "Scenario 1". The CBT may also be forced to increase its average funding rate higher than the first scenario.

Scenario 2 would lead to a very positive market reaction, though slightly less so compared to the previous scenario

Although we expect a very strong initial market reaction similar to "Scenario 1", this option may have some pitfalls, in our view. That is, in this scenario, the gap between O/N rate and the LLW rate widens significantly, which may limit the monetary policy effectiveness over the medium term. We consider this move as a further step away from simplified monetary policy.

Probability:

5-10%. We do not attach a high probability to this scenario, either, as it would be difficult to explain politically.

SCENARIO 3: 150-175 BPS HIKE IN THE LLW RATE TOGETHER WITH A 175-200 BPS HIKE IN THE O/N RATE

Reasoning:

This scenario is a middle-way strategy (between option a and option b), i.e. the CBT prefers to maintain its current monetary policy standing, but wants to take a step towards normalization by limiting the usage of the LLW rate to some extent.

Scenario 3 is similar to the first scenario in practice, though its effectiveness will be much more limited, as the monetary policy flexibility is lower

This is also similar to the scenario 1 in practice. The CBT may opt for this strategy as it would be easier to defend politically. Nevertheless, the effectiveness of this strategy will be much more limited, as the monetary policy flexibility is lower (the gap between the funding rate and the LLW) and the CBT would still need to keep the usage of the LLW at 60-70% in order to achieve a 50-75 bps hike according to the current situation.

Market Impact:

Under this scenario, we would still expect a strongly positive initial market impact (though to a lesser extent than the first two scenarios), as this move would be far above the current market expectation.

Probability:

10-15%. Although this scenario has a slightly higher possibility than the first two scenarios, we still do not attach a high likelihood given our experience of the CBT's previous policy moves and statements.

SCENARIO 4: 150-175 BPS HIKE IN THE LLW RATE

Reasoning:

The CBT may opt for this scenario if it wants to give a strong message to the market when continuing to use the LLW rate as its main funding channel.

This scenario is suited for "option a"; the CBT may opt for this alternative, if it wants to give a strong message to the market when continuing to use the LLW rate as its main funding channel. In that scenario, the CBT may set the LLW usage at 80-90% and determine a funding rate at around 13.00-13.5%. It would still have some monetary policy flexibility (25-75bps), as it could shift all funding to the LLW.

Market Impact:

We would expect the initial market impact to be positive, as it exceeds market expectations. Nevertheless, global sentiment would still play a key role in the evolution of rates and currency, and the market could force the CBT towards further rate hike(s) at upcoming meetings.

We attach a higher probability to this outcome compared to the first three scenarios, but still not significant due to its political consequences.

Probability:

15-20%. We attach a much higher probability to this outcome compared to the first three scenarios, but still not significant due to its political consequences.

SCENARIO 5: 75-100 BPS HIKES IN BOTH THE LLW AND O/N RATES

Reasoning:

This scenario is also suited for "option a; the CBT sticks to its current monetary policy standing with a tighter approach. It may increase its average funding to 12.75%-13.00% by keeping the LLW usage at 90% (as was the case before 22 Nov). It would still have some 25 bps flexibility to hike the average funding rate.

Scenario 5 is actually our base-case, as it would more than satisfy the market's rate hike expectation, and on the other hand would be much easier to defend politically.

Market impact:

We would expect a slightly positive initial market impact, but the evolution of rates will be susceptible to shifts in global sentiment, and the CBT might be forced to hike rates further at upcoming MPC meetings.

Probability:

40-50%. This is actually our base-case scenario, as it would more than satisfy the market's rate hike expectation, and on the other hand would be much easier to defend politically. Therefore, it may be defined as a middle-way strategy, similar to CBT's previous moves.

SCENARIO 6: 100 BPS HIKE IN THE LLW RATE

Reasoning:

Scenario 6 (100 bps hike in the LLW rate) is the wider market expectation

This option would match the wider market expectation, and would also be easier to defend against political pressures. Under this scenario, we believe that the CBT will keep LLW usage at 90-100% and increase its average funding to 13.00-13.25% range. By that, the CBT would stick to its current monetary policy standing, but at the same time would tighten its stance.

Market impact:

We would expect a neutral-to-slightly-positive initial market reaction. The positive impact may linger into the coming days if global sentiment remains optimistic. We also think that the rate hike option at upcoming MPC meetings will be on the table, depending on global sentiment.

We attach the wider market expectation a 20-30% probability, as in this case, the CBT would have no flexibility to increase its average funding rate between MPC meeting dates.

Probability:

20-30%. Although it is the wider market expectation, we attach a somewhat high, but a lesser likelihood for this outcome than our base-case (Scenario 5), as in this case, the CBT would have no monetary policy flexibility to increase its average funding rate between MPC meeting dates. We also think that, if the CBT were to hike rates, it would prefer to do something more than what the market already expects.

SCENARIO 7: 50-75 BPS RATE HIKE IN THE LLW RATE

Reasoning:

The CBT may opt for this scenario due to political pressure.

In case of a lesser magnitude LLW rate hike than 100 bps, we would expect negative market sentiment at the initial stage

Market Impact:

We would expect negative initial market sentiment; the TRY to depreciate and the long-end of the yield curve to shift upwards. If global sentiment remains upbeat, this should limit the extent of any negative reaction, or else we may even retreat to current prices in the coming days.

Probability:

If the CBT were to hike rates, it would prefer to do something more than what the market already expects, or else meet market expectations, at the very least.

5-10%. We attach little likelihood to this scenario, since we believe that (as already stated above) if the CBT were to hike rates, it would prefer to do something more than what the market already expects, or else meet market expectations, at the very least.

SCENARIO 8: 50BPS RATE HIKE IN EACH OF THE LLW, O/N AND WEEKLY REPOS

Reasoning:

Considering the political pressure, the CBT may opt for symbolic 50 bps rate hikes in each of the LLW, O/N and the weekly repo rates, even though it would continue to fund the market through the LLW channel.

Considering the political pressure, the CBT may opt for only symbolic 50 bps rate hikes in each of the LLW, O/N and the weekly repo rates

Market Impact:

The market impact would be similar to the previous scenario (Scenario 7).

Probability:

0-5%. Similar to the previous scenario (Scenario 7).

SCENARIO 9: NO RATE HIKE:

Reasoning:

The CBT may opt for this option as market sentiment has already improved since early December, and the favorable base effect is expected to lead to a significant decline in CPI inflation from 13.0% to 10%, or below in the next few months. Last but not least, President Erdogan, yesterday reiterated his objection to high interest rates.

We cannot imagine the CBT ruling out the unanimous market expectation and shying away from even a symbolic move.

Market Impact:

We would expect a sharp negative market reaction at the initial stage. In upcoming days, global sentiment will continue to be the determining factor, although there might be a significant chance of the CBT being forced to hold an extraordinary MPC meeting.

Probability:

0-5%. We cannot imagine the CBT ruling out the unanimous market expectation and shying away from even a symbolic move.

MPC's alternative interest rate scenarios at the 14 Dec meeting:

		Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
Action	:	200-250 bps hike in LLW + 300-350 bps hike in O/N	200-250 bps hike in LLW	150-175 bps hike in LLW + 175-200 bps hike in O/N	150-175 bps hike in LLW	75-100 bps hike in LLW +75-100 bps hike in O/N
LLW (%)	:	14.25-14.75	14.25-14.75	13.75-14.00	13.75-14.00	13.00-13.25
O/N (%)	:	12.25-12.75	9.25	11.00-11.25	9.25	10.00-10.25
Weekly Repo (%)	:	8.00	8.00	8.00	8.00	8.00
Avg. Funding (%)	:	12.50-13.00	12.75-13.00	12.75-13.00	13.00-13.50	12.75-13.00
Flexibilitiy to hike (bps)	:	150-200	150-200	75-100	25-75	25
Usage of LLW (%)	:	0-25	70-80	60-70	80-90	90
Probability (%)	:	0-5	0-5	10-15	15-20	40-50

		Scenario 6	Scenario 7	Scenario 8	Scenario 9
Action	:	100 bps hike in LLW	50-75 bps hike in LLW	50 bps hike in LLW + 50 bps hike in O/N + 50 bps hike in weekly	No hike
LLW (%)	:	13.25	12.75-13.00	12.75	12.25
O/N (%)	:	9.25	9.25	9.75	9.25
Weekly Repo (%)	:	8.00	8.00	8.50	8.00
Avg. Funding (%)	:	13.00-13.25	12.50-12.75	12.50-12.75	12.25
Flexibilitiy to hike (bps)	:	0-25 bps	0-25	0.-25	0
Usage of LLW (%)	:	90-100	90-100	90-100	100
Probability (%)	:	20-30	5-10	0-5	0-5

- *Please note that, the sum of the probabilities of the above mentioned scenarios may not necessarily add up to 100%*

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