Turkey: Euro-zone pick-up and lower oil price good for equities

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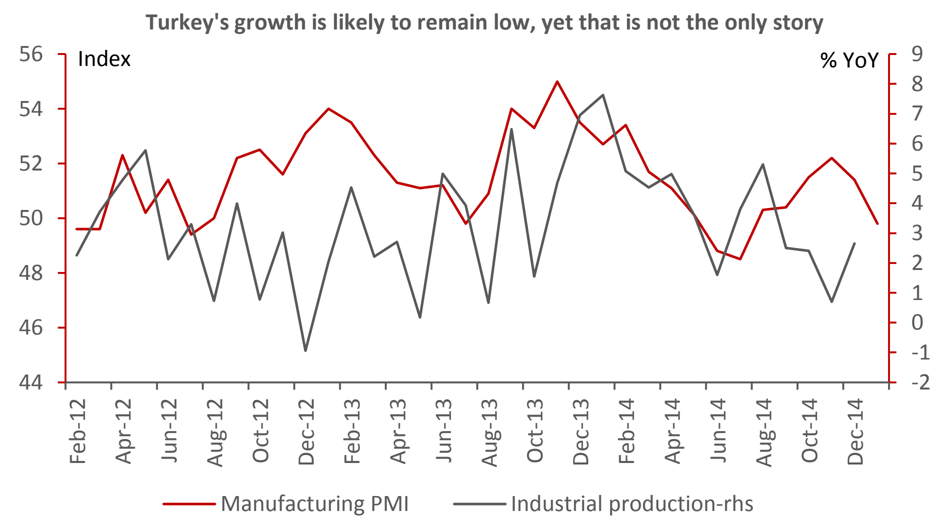
- **Turkey's structural adjustment will require continuing fiscal and monetary prudence**
- **Restrictive fiscal and monetary policies – known as the necessary "structural adjustment process (SAP)" – will keep growth at bay**
- **Low domestic growth is, however, not incompatible with a pick-up in equity markets**
- **The main drivers for equity markets may well be a pick-up of demand in the Euro-zone (turkey's main export market) *combined* with a weaker Turkish lira**
- **Structurally the rise in equity markets is warranted by the strong core financial sector, viz. banking sector as well as comfortable public finances, as well as low valuations**
- **The key domestic risks are political, i.e. the government interfering in the Central Bank's monetary policy, thereby preventing a reining in of inflation (which is currently too high)**
- **A further deterioration in neighbouring Syria and Iraq is an additional risk factor**

Equity pick-up still in the cards even in the context of weak domestic growth, monetary policy failure the key domestic risk

We argue that domestic growth will remain weak in Turkey in the near term as credit growth and fiscal stimulus will remain contained. A pick-up in demand from the Euro-zone (Turkey's largest client), a weak oil price, and a competitive Turkish lira should still be able to boost the local equity market. This is ever so true while Turkey's banking sector has become considerably more resilient over the last years. Thus financial markets could do well, even in a context of continuing weak growth. There are two key risks to this scenario. One is domestic, i.e. the Central Bank of Turkey (CBRT) does not live up to fighting inflation as it should. This risk would then be compounded if the external financing sector would seriously deteriorate in which case Turkey would be more vulnerable than countries such as India and Indonesia. This higher risk for Turkey is also reflected in valuations which are more interesting than for many other emerging markets. Thus the higher risk is – as often – associated with a higher reward potential.



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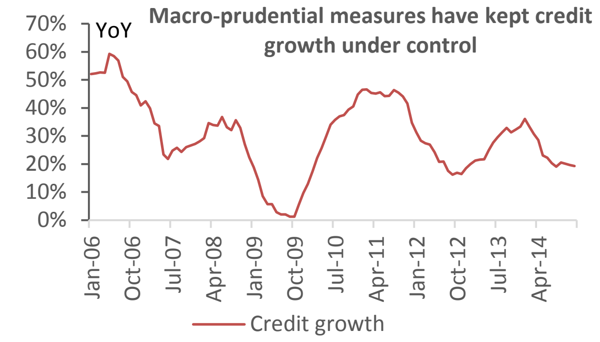
Growth dynamics likely to stay weak in the near term as monetary and fiscal conditions remain restrictive

The so-called "structural adjustment process" Turkey is undergoing entails first and foremost a continuing slowdown in the credit growth such that savings can gradually pick-up. In addition to that the government will have to keep the fiscal deficit under control.

The slowdown in credit growth has by and large been steered by the central bank, via the imposition of macro-prudential measures.



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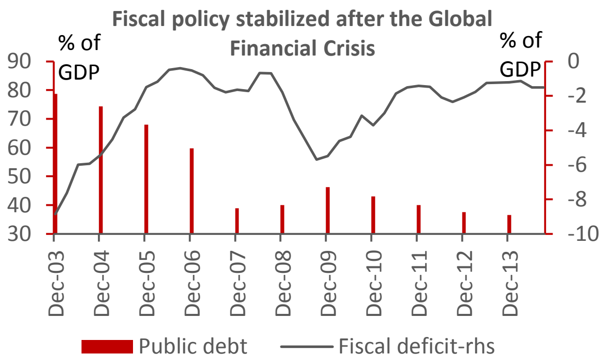
The stabilization of the country's fiscal deficit at less than 2% of GDP is another important factor in keeping growth at bay.



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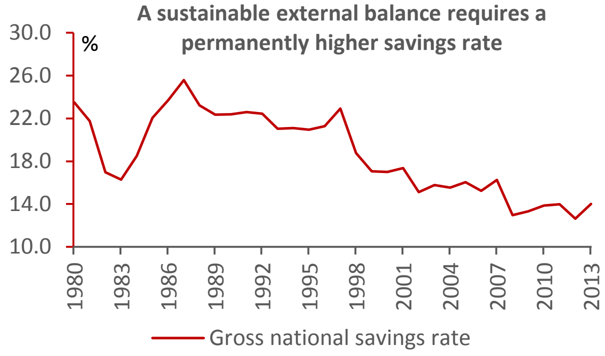
Turkey's growth unfriendly policies are not a matter of choice

It might be worthwhile to note that Turkey has very little room for discretion when it comes to economic policy. Indeed, the high current account deficit is entirely rooted in a massive fall in the savings rate, as of today still at a 30 year low. Thus, unlike other emerging markets, stabilizing the macro-economic situation, requires first and foremost, promoting a significant increase in domestic private savings.



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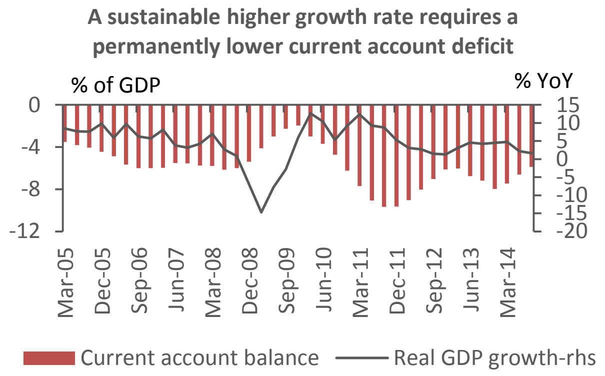

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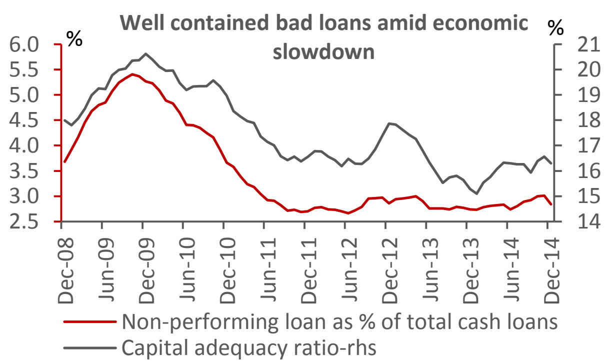
But banking sector is in relative good shape as long as there will be no significant deterioration of the external financing environment

In spite of lower growth, the banking sector has gained in resilience with both gross non-performing loans and capital adequacy ratios stabilizing at decent levels. Critically, however the sector would still be vulnerable if the external financing sector would significantly deteriorate.



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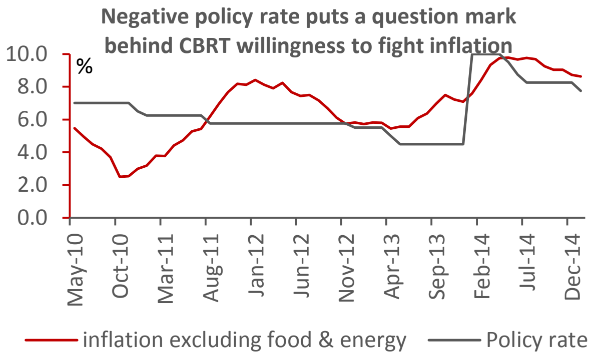
The key domestic risk remains the government meddling in monetary policy

Precisely because Turkey needs to permanently and structurally push up its domestic savings rate, the Central Bank of the Republic of Turkey (CBRT) must stay its course as far as fighting inflation is concerned. In fact, high inflation erodes purchasing power, thereby encouraging consumption rather than savings. Thus any interference by the government, always a risk, is even more dangerous for Turkey's long term macro-economic stability. The current frontloading of monetary easing has already determined a negative real policy rate. This carries therefore the risk of affecting sentiment negatively in the near term as investors lose confidence in the central bank's ability to contain inflation. It is the recent rate cuts that have deteriorated sentiment in the domestic financial market.



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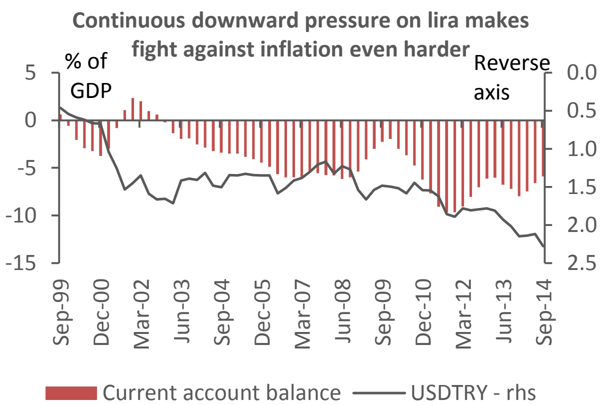
High current account deficit makes currency vulnerable, further stoking inflationary potential

It is true that the current account deficit has narrowed in recent quarters and is likely to improve further in the wake of lower global energy prices and slower domestic economic growth. Yet, it remains very high as a proportion of Gross Domestic Product. As such, the Turkish Lira remains one of the more vulnerable currencies in case of a deterioration of the external financing environment.



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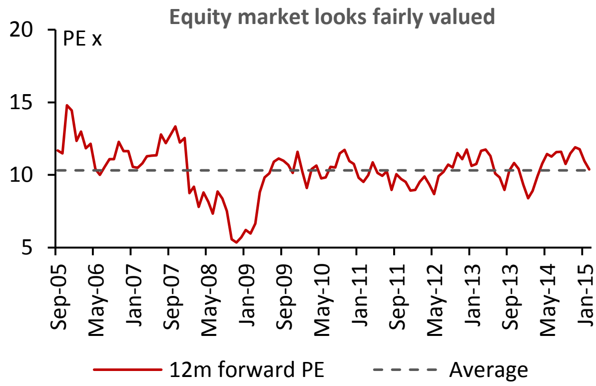
Implications for investments

Whilst monetary policy remains a key risk, progress on structural reform – together with lower oil prices and a pick-up of demand from the Eurozone – do provide upside to local equities. Higher domestic savings together with a more resilient banking sector will lift equities as long as the external financing environment would not significantly deteriorate.

Thus we attach a higher risk to Turkey than, say, India or Indonesia. Having said so, the higher risk is – as always – associated with a bigger reward potential. This is clearly reflected in the valuation of the country's equity markets, which are fairly valued in absolute terms and interestingly valued in comparative terms.



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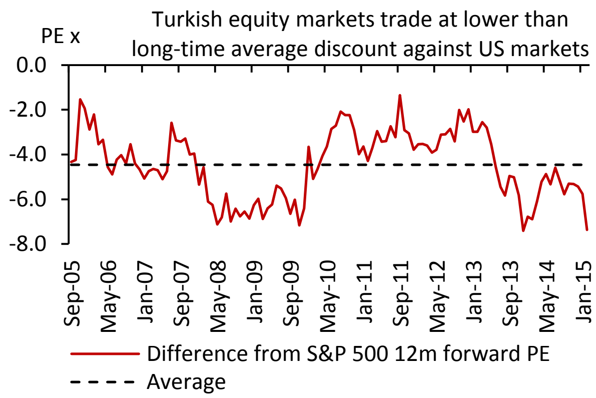

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Sources

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2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
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