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March 19, 2017

TURKEY

Political and Economic Update

EXECUTIVE SUMMARY

There was dearth of new branded polls last week, which is rarity for Turkey. Several pollsters commented that because of the high ratio of undecideds they have chosen not to publish results. Less reliable evidence confirms our finding that the race is a dead heat. We suspect AKP will find new gimmicks to win, which might spook the markets and cause permanent damage to diplomatic relations.

We currently bet that the row with EU members is just a ploy to win the referendum, but EU might have drawn different lessons. We would not rule out a suspension of accession process by the EU, unless Turkey decides to return to the path of democracy soon.

In Syria, new evidence suggests that the U.S. is unlikely to include the Turkish Army in the Raqqa campaign, while Russia wants it out of Syria. Syrian Kurds are exploit ing Turkey's diplomatic isolation to accelerate nation-building, which renders it difficult for Ankara to pull out.

There were a number of important data releases this week. The 12-month rolling current account deficit (CAD) widened a bit more than we expected. Inflows recovered somewhat in the month, but in 12-month rolling terms, they continue to fare markedly below CAD, necessitating the use of CBRT reserves and/or increasing reliance on unidentified inflows. (Un-)employment and budget data were both poor, while the 24-month ahead inflation expectations were at their highest level since the data has begun to be compiled.

Corporate sector's foreign exchange position is finally receiving the attention it needs from the government, it looks like, but being a CAD country poses a dilemma of sorts in the tackling of the problem.

Moody's downgraded Turkey's sovereign outlook to negative from stable, citing growing "domestic and external pressures on Turkey's credit profile". The Agency seems particularly concerned about government's efforts to boost growth in the short term observing that, "weaker growth is negatively impacting Turkey's key credit anchor -- its healthy public finances and low government debt." A bigger problem is that leaving the referendum behind will solve little in the way of soothing the concerns raised by Moody's.

Cosmo says thanks to a newly vigilant CBRT, markets are safe and possibly profitable until the referendum, but a sell-off is very likely afterwards.

POLITICS

Referendum Race: We need new gimmicks

With only 4 weeks left to the ballot day, we can report no new branded polls, which is a very strange development for an absolutely poll-hungry country like Turkey. There are several juicy tidbits, on which we will focus, but first we need to mention an article by Bloomberg Turkish news service, which inquired 4 major polling agencies as to why they are not reporting results. The answer was unanimous: "Way too many undecideds, which could break either way any minute." AKP's own polls reportedly reached the same conclusion about a good portion of their own base, as well as a very large segment of MHP voters.

We have one poll, or the rumor thereof, by center-left and somewhat reliable Gezici, which shows NO camp ahead by 51.1-48.9%, but it too determines a very large percentage of undecideds. More interestingly Gezici also insists that the row with Netherlands and Germany is yet to affect voter choices.

Hurriyet columnist and AKP's close friend Mr. Abdulkadir Selvi heralds that NO votes had peaked, with YES votes beginning to swell, but reading the article one gets the impression that MHP is still in upheaval, while HDP is beginning to mount an effective NO campaign in Kurdish-majority cities. We link the article here for those readers who are familiar with Turkish to judge for themselves. We don't usually take polls commissioned by the parties too seriously, but for what it is worth, CHP members claim their own finds NO votes ahead by 4 points, with 12% of the electorate still unable to make up its mind. Finally, in an article, T*he Economist* asserts that the YES votes are "a bit under 50%", without proffering specific evidence or a poll.

We have sworn not to speculate on the motives of Turkish voters, but certain trends are too obvious to miss. First, AKP is in near-panic, judging from the increasing pressure on the NO campaigners. Provincial governors and local authorities routinely deny permits for mass meetings, even town hall gatherings. Rallies by MHP rivals are frequently broken up by (presumably) men that are loyal to Bahceli.

We suspect the fracas with EU is another ruse to raise the excitement level among the nationalist-Islamist base, which will be the subject of the next essay. There is also a subtle change in propaganda tactics. Now, instead of claiming a NO vote would embolden Gulenists and PKK (which is not selling too well), AKP is threatening the voters with early elections in case of rejection (i.e. with more political instability).

Next, throughout the week we have witnessed enough local rebellions in the MHP rank-and-file to allow us to reach the conclusion that a majority of party members will not vote YES. Regarding Kurds, we can bet the house that they will not support these amendments, but the pressure and intimidation factors are so unbearable, we are not sure whether they would report to the ballot box, or sullenly remain home.

Third, while AKP's pork-barreling is doing a good job perhaps in terms of reviving production, the slow pace of consumer loans and a very modest recovery in March preliminary consumer confidence index of BloombergHT suggest the men and women on the street are still not feeling too good, which is always a negative for the YES camp.

All this being said, we remind our readers that this vote is must-win for AKP, which feels besieged by enemies at home and abroad which is not fully delusional. It does have many enemies. The OSCE fetched a team of election monitors to ensure a level playing field, but we can't rule out foul play. We also can't rule out new gimmicks. The next two essays will focus on these new gimmicks.

Turkey and EU: Is it a closed book?

Throughout the week, AKP members, at times joined by Bahceli continued their broadside of slurs and insults on countless EU members. We feel these have received adequate global media attention for their inventiveness and poor taste, hence forego a broad recount of what has been said. While it can be argued that authorities in Netherlands and Germany might have treated AKP politicians less than fairly, and the bans on them visiting the country spreading to Sweden, Denmark and Austria are somewhat Islamophobic, there is no argument that AKP has blown up the crisis out of proportion.

Therefore, we focus on two important questions, which judging by market reaction; have not received sufficient attention by the investors:

- Is Ankara using this opportunity to bolster YES votes, or are we facing something more sinister?
- How will the EU treat the Turkey dossier when this whole election mess (theirs and ours) passes away?

We currently bet that with 80% probability AKP intends to squeeze more votes out of the imbroglio with EU and will make U-turn after the referendum to restore relations. There is a 20% probability that Ankara will carry out its threat of officially revoking the Refugee Readmission Treaty now or after the referendum and allow Syrian refugees to reach the gates of Europe, as a signal that it is done with accession. Our betting is largely based on statements by several Cabinet members such Mr. Mehmet Simsek and Mr. Canikli to the effect that economic integration with EU shall deepen. Moreover, while “high level diplomatic relations” with Netherlands was frozen, Ankara made no attempt to back up its insults on PM Rutte with any economic sanctions. We feel Ankara understands that without the perspective of membership in the future, or at least a “special status” relationship it would not be possible to maintain the current level of mutually beneficial economic activity and receive the FDI and tourist flows.

On the other hand, we do admit to hearing scary rumors about Erdogan being exasperated by EU’s reluctance to help out with the purge of Gulenists and PKK sympathizers presumably taking refuge in their countries, as well as the never ending critique about Turkey’s human rights deficiencies. The current escalation of tensions with EU could be dress rehearsal to a radical change in Turkish diplomacy if he wins the referendum which would involve officially denouncing accession, introducing the death penalty, and even perhaps forming a loose federation with Turkish Republic of Northern Cyprus.

Getting back to our base-case of this fracas with EU merely being a new gimmick to raise “voter awareness”, the simplest prediction to make is that the show-down must be sustained until the election day because Turkish voters forget quickly) and if possible EU must be enraged sufficiently to draw concrete responses of retaliation to create stories of martyrdom like the forceful expulsion of Family Affairs Minister Mrs. Kaya from Netherlands.

This would be a very dangerous game. Already, Germany permitted Turks voting in its country only under the condition of AKP ceasing its invectives. Withdrawing the permit could cost AKP something like 500K votes and more if other EU countries emulate the ban. Moreover at some point the escalation between the parties will be taken seriously by the markets, thus hurting AKP’s chances of scoring a victory.

Moving over to the other side, we doubt EU leaders would forget easily the abuse heaped upon their honor. Also, it would not escape notice that Rutte’s party might have done better than the polls had indicated by standing up tough to Turkey. This observation might mean French and German authorities would adopt a more robust posture towards Turkey in the coming days.

Yet we seriously fear that EU might be ready to suspend accession, or might be forced to if the constitution is adopted. The Parliamentary Assembly of Council of Europe asked the Venice Commission, a world renown judicial body of experts to evaluate the proposed constitutional amendments. The verdict was damning to say the least. The following bullet points are from a summary issued on 10th of March, but the full text can be found in this link.

"The Venice Commission warns that by removing necessary checks and balances, the amendments would not follow the model of a democratic presidential system based on the separation of powers, and instead would risk degeneration into an authoritarian presidential system. Concluding concerns from the opinion include the following:

- letting the new President exercise executive power alone, with unsupervised authority to appoint and dismiss ministers, and to appoint and dismiss all high officials on the basis of criteria determined by him or her alone;
- allowing the President to be a member and even the leader of his or her political party, that would give him or her undue influence over the legislature;
- giving the President the power to dissolve parliament on any grounds whatsoever, which is fundamentally alien to democratic presidential systems
- further weakening the already inadequate system of judicial oversight of the executive.
- further weakening the independence of the judiciary.

The opinion, which had been requested by the Monitoring Committee of the Council of Europe's Parliamentary Assembly, raises serious procedural concerns".

Venice Commission also issued a report Turkey's emergency decree laws and their relation to media freedom, which is no less critical than the one on the constitutional amendments. According to Turkish experts, Council of Europe will put Turkey on monitoring list on April, i.e. strip off full membership. We feel the passage of the referendum will give EU leaders enough ammunition to suspend accession on account of Turkey having lost its democratic credentials if they wish to do so. We believe a debate of this nature is currently taking place and might be finalized after the German elections at Turkey's expense, unless by then the State of Emergency is lifted and Erdogan will have made some progress towards improving democratic standards.

The downgrading of the relationship with EU is very likely to hurt the economic relationship and Turkey's risk profile, a topic we will elaborate more on if and when we have more evidence.

Turkey in Syria: No one wants us there

According to Hurriyet Daily's experienced correspondent Murat Yetkin, during last week's summit between the military chiefs of staff of Turkey, Russia and the U.S., Gen Hulusi Akar has been told more or less in concrete terms that his Army is not wanted in the Raqqa operation. To add insult to injury, his Russian colleague advised him to pull out of Syria as soon as possible.

Events on the field verify this account of events. Currently, an odd coalition of Russian and American troops patrol Kurdish-occupied and mixed population city of Manbij, Turkey's next target after capturing al Bab, to make sure it is not invaded by Turkey. Pentagon already began bringing in heavy artillery (which would have been one of the primary contributions of Turkey) to support the Kurds (PYD-YPG) in the Raqqa campaign. According to Kurdish sources the siege of the DAESH capital might begin as soon as April, though we believe Pentagon would defer the official announcement until after the Turkish referendum to prevent a rash reaction by Ankara such as attempting to invade one of the three Kurdish cantons abutting the Turkish border.

Stopped by a coalition of American, Russian and Syrian troops, Ankara ought to see the writing on the wall and start looking for a graceful exit. Unfortunately, PYD-YPG is not smart enough to grant Turkey the diplomatic cover to do so. As soon as Russian-American troops began patrolling the streets, Kurds convinced the citizens of Manbij to declare "democratic autonomy", a word used by PKK in THE Ditch Wars in Turkey, establishing a city council with substantial Kurdish participation. In other words, contrary to Turkish demands, PYD-YPG has no intention to vacate Manbij, as it considers the city part of its motherland in Syria.

Later in the week, it declared a federated autonomous zone in Northern Syria covering its three cantons. Even though none of the actors recognize this new entity, neither are they doing anything to stop it from nation-building. According to Turkish military analysts, PKK is investing heavily into administration, logistics networks and military training of the local population and does intend to use the fledgling state to eventually broaden its war of secession in Turkey. Ankara in return signaled that it will not bow to the *fait accompli* presented to it by the two Great Powers by announcing the formation of a new Sunni Arab Tribal Army, consisting of the members of 50 tribes located in North-East Syria.

We are not sure whether Ankara intends to attack the Kobane or Jazeera cantons before the Raqqa operation to blackmail the U.S to include its forces, or play the long game and wait for U.S. forces to finish off DEASH and pull out of Syria before tangling up with Kurds. Either way, Turkey is not done with Syria, nor have the "downside" scenarios receded in the horizon.

ECONOMICS

February Budget: As bad as signaled by cash budget…

As we've reported last Sunday based on the cash-budget data, tax revenue tanked and primary expenditures surged in February, in inflation-adjusted terms, leaving us with a primary deficit of some TL1.8 billion in the month, compared with a surplus of TL6.5 billion in the same month of last year. The 12-month rolling primary surplus hence deteriorated to just under TL21 billion in February, from over TL29 billion in January (with a similar deterioration observed in the IMF-defined primary balance, which slid to an estimated *deficit* of TL16-17 billion from around TL8 billion in January). Primary expenditure growth was driven by transfers (notably social security), which expanded at a whopping (inflation-adjusted) near-30% rate, while weakness in tax revenue was likely driven by a combination of tax concessions on white goods, weakening amnesty revenue as well as relative weakness in economic activity (see table; charts).

The bottom line is that stimulus measures and a weak economy are beginning to take their toll on the budget, exactly as we've been fearing but probably more so than we thought. As we covered in our last Quarterly (of February 12, 2017), we are working with an overall central government deficit of some TL57 billion (or 2% of GDP) compared with the official target of some TL47 billion, or 1.6% of GDP for the moment, but this is, admittedly, looking to be on the optimistic side already. Our bet for a relatively modest slippage was driven by our expectation of the government taking corrective action in the latter part of the year, i.e. once the referendum is out of the way, which was encouraged by earlier statements from Finance Minister Mr. Naci Agbal, but we are no longer sure such action is feasible in the current political environment -- no matter how the referendum outcome plays out -- especially in the light of Minister Agbal's more recent statements to Bloomberg, that the overall deficit target may be breached by 1% of GDP.

Incidentally, this eventuality seems to be a key reason behind the Moody's downgrade of the outlook from stable to negative, as mentioned in the Executive Summary.

Lastly, bear with us as we share a technical take on the figures mentioned in the Bloomberg article: note that the 1.9% of GDP deficit target of the MTP cited in the interview, is based on the old GDP; if it is in fact correct that the deficit target will be breached by 1% of (presumably new) GDP, as Minister Agbal is saying, we could see the overall deficit rise to TL75 billion, compared with the targeted TL47 billion, which would amount to an overall deficit of 2.6% of (our) GDP estimate for the year as a whole, making our 2% estimate look rather optimistic.

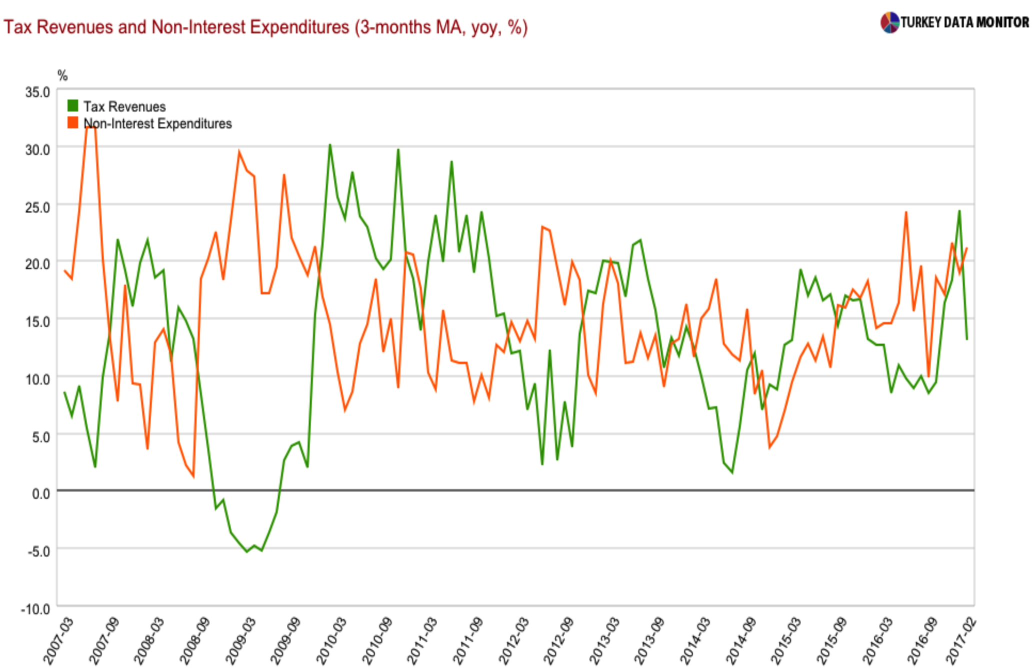
Central Government Budget: 2016-2017

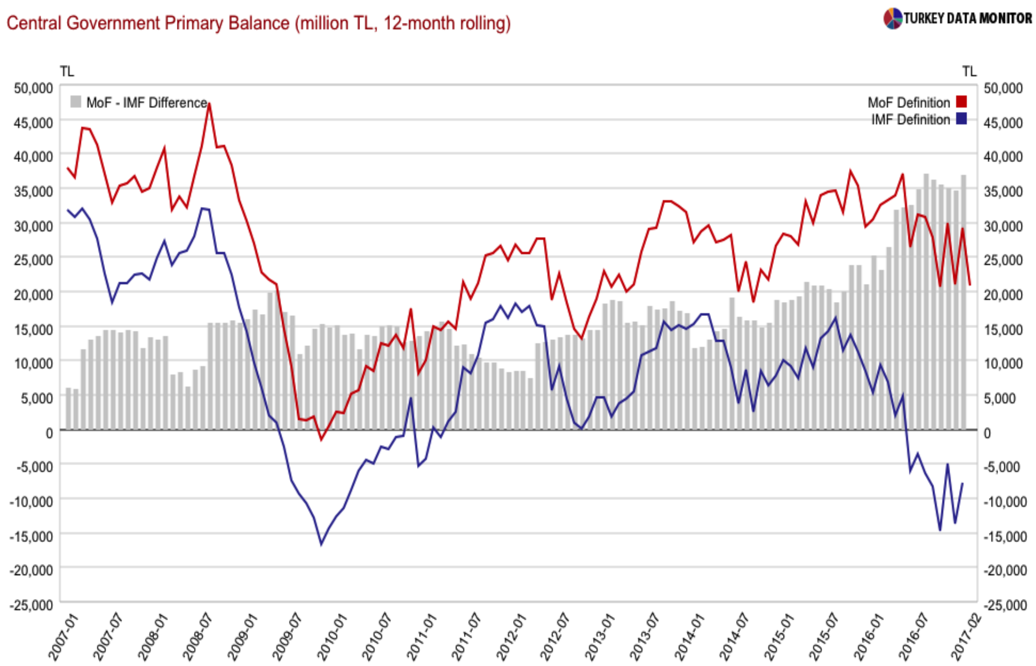
(in billion TL)

	Feb.		Real growth (%)	Jan.-Feb.		Real growth (%)	As % of Orginal Budget	2017
	2017	2016		2017	2016			Budget
Central Government Revenues	46.9	44.7	-4.8	105.7	91.4	5.4	17.7	598.3
o/w: General Budget Revenues	44.5	42.5	-4.9	101.2	87.7	5.3	17.3	584.3
Tax Revenues	40.0	38.4	-5.3	88.4	78.0	3.3	17.3	511.1
o/w: Tax on Income	17.3	15.3	2.6	28.3	25.0	3.2	18.2	155.1
Income Tax	6.1	5.8	-3.8	16.6	15.2	-0.8	15.2	108.9
Corporation Tax	11.2	9.5	6.5	11.7	9.8	9.6	25.4	46.2
Tax on Goods and Services	11.4	11.9	-13.1	34.5	31.2	0.9	16.3	212.3
o/w: VAT	3.4	3.5	-12.1	11.7	10.5	2.2	20.5	57.1
SCT	6.7	7.2	-16.2	19.6	17.9	0.2	14.4	136.4
Tax on Foreign Trade	8.3	7.3	2.7	15.1	12.1	13.9	15.6	96.8
Non-Tax Revenues	6.9	6.4	-1.5	17.3	13.4	17.5	19.8	87.2
Expenditures	53.7	42.3	15.3	101.1	84.8	8.7	15.7	645.1
Non-Interest Expenditures	48.7	38.2	15.7	89.4	75.1	8.6	15.2	587.6
o/w: Personnel (inc. soc. sec. premiums)	14.9	13.7	-1.7	33.9	31.2	-0.8	17.9	189.8
Current Transfers	26.1	18.7	27.1	44.4	34.6	16.8	17.8	249.3
o/w: Social Security	14.5	9.3	41.5	25.1	17.8	28.8	20.8	120.8
Local Administrations	5.6	4.6	10.9	10.1	8.6	7.3	17.3	58.4
Investment	2.1	1.5	23.7	2.4	2.0	12.6	3.1	77.1
Interest Expenditures	5.1	4.1	12.0	11.7	9.7	9.3	20.3	57.5
Overall Balance	-6.8	2.4	…	4.6	6.6	…	-9.8	-46.9
Primary Balance	-1.8	6.5	…	16.3	16.4	…	152.7	10.6

Source: Ministry of Finance, Turkey Data Monitor.

Tax Revenues and Non-Interest Expenditures (3-months MA, yoy, %)





BOP: Wider CAD, continued reliance on unidentified flows and reserves

The current account deficit (CAD) was $2.8 billion in January, which drove the 12-month rolling deficit higher to $33.2 billion, from $32.6 billion a month earlier (see table; chart).

The main driver is a somewhat wider energy deficit, as expected, on the back of higher oil prices, against a backdrop of moderate improvement in the core balance, i.e. overall balance less energy and gold grade.

Current Account Developments
(in millions of US$)

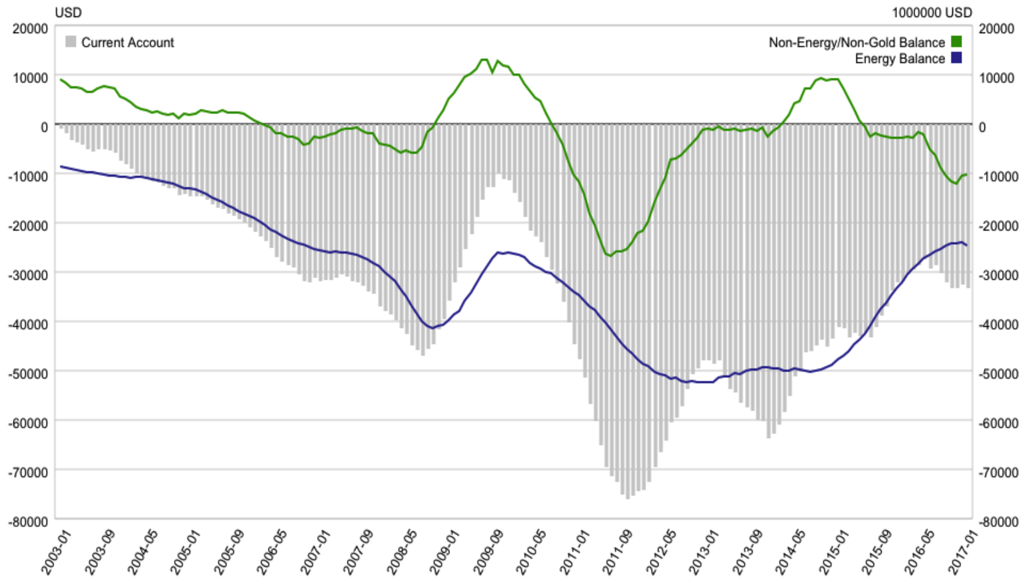
	Jan		12-month rolling	
	2017	2016	Jan 17	Dec 16
Current Account Balance	-2,762	-2,201	-33,163	-32,602
o/w: Core Balance 1/	-52	-240	-10,253	-10,442
Trade Balance	-3,105	-2,685	-41,247	-40,827
Exports	11,857	9,989	152,055	150,187
%	19	-22	2	-1
Imports	14,962	12,674	193,302	191,014
%	18	-20	-2	-5
Services (net)	578	810	15,193	15,425
o/w: Tourism (net)	589	714	13,835	13,960
%	-18	-26	-34	-34
Income (net)	-399	-441	-8,947	-8,989
o/w: Interest Expenditure	283	314	5,604	5,635
Current Transfers	164	115	1,838	1,789

Source: CBRT, Turkey Data Monitor.

1/ Current account less energy and gold balances.

Current Account Balance (12-m rolling, million USD)

TURKEY DATA MONITOR

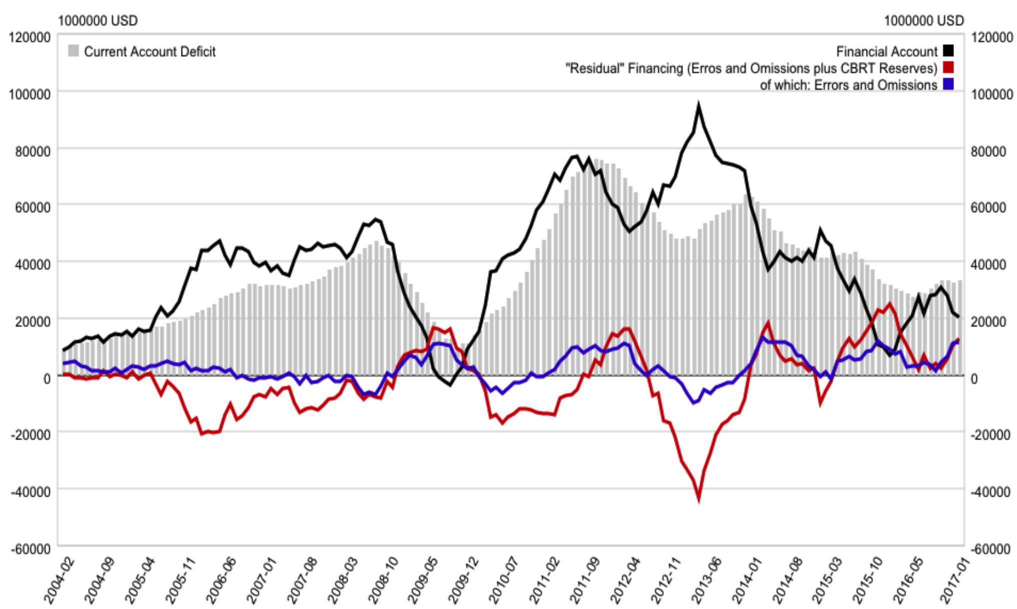


In fact, we estimate that the latter has moved to moderately positive territory in February (not shown) on a monthly basis. While this is good news, we don't expect it to continue for much longer, as the tourism season kicks in (with little improvement over last year) and exports start to lose momentum later in the year. We are working with a CAD of around $36 billion this year.

On the financing side, although portfolio flows picked up, total capital inflows were not adequate to finance the CAD, with the slack being picked up by another month of reserve drawdown by the CBRT. The other "residual" financing item, errors and omissions were negative this month, though they remained hugely positive in cumulative terms in the past 12-months through February (at over $11 billion; see chart; table).

Current Account vs. Financing Flows (12-month rolling)

TURKEY DATA MONITOR



Financial Account Developments
(in millions of US$)

	Jan		12-month rolling	
	2017	2016	Jan 17	Dec 16
Current Account Balance	-2,762	-2,201	-33,163	-32,602
Capital Transfers	-16	15	-8	23
Financial Account	-1,410	-3,249	-20,318	-22,157
Direct Investment	-360	-789	-8,687	-9,116
Portfolio Investment	-1,584	1,096	-9,036	-6,356
o/w: Equity	649	-261	1,733	823
Debt Securities 1/	959	-526	8,465	6,980
o/w: Domestic Issues	-802	-93	114	823
Other Investment	534	-3,556	-2,595	-6,685
Assets	2,847	-1,256	10,302	6,199
Liabilities	2,313	2,300	12,897	12,884
Short Term Loans	1,168	143	-680	-1,705
Long Term Loans	-130	-223	10,508	10,415
o/w: Corporate Sector	-263	-91	8,532	8,704
IMF Credits	0	0	0	0
Other / Deposits	1,275	2,380	3,069	4,174
Net errors and omissions	-687	-1,100	11,648	11,235
Reserve Assets	-2,055	-37	-1,205	813

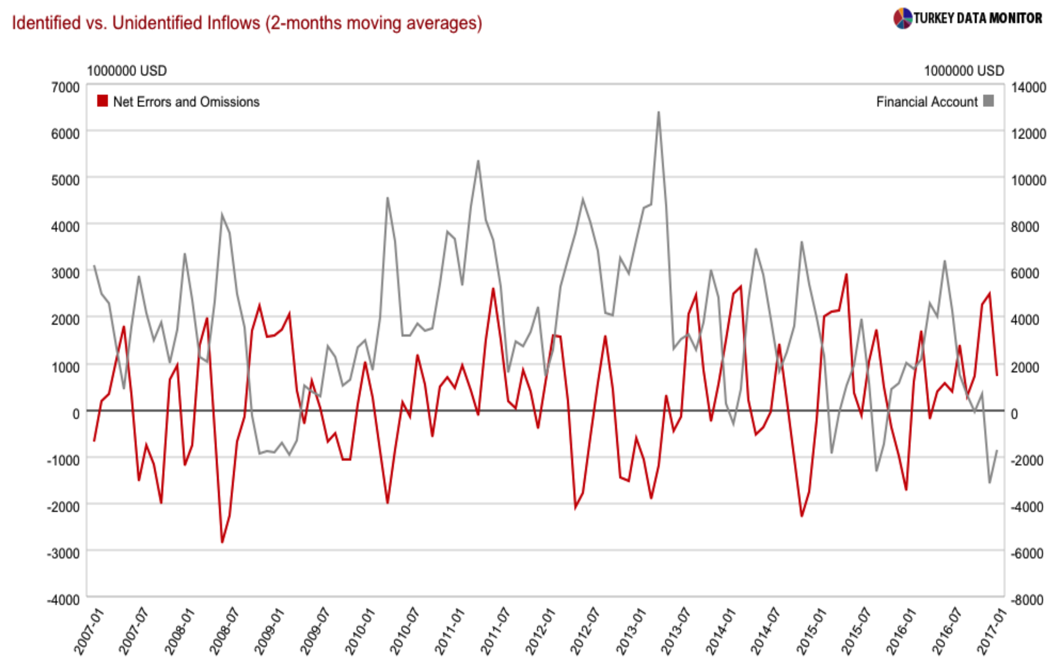
Source: CBRT, Turkey Data Monitor.
1/ Including domestic issues to non-residents.

In February, banks' assets abroad rose by $2.8 billion (classified in the above table under Other Investment/Assets), which triggered some speculation in the media and the cyberspace that this may simply mean "capital flight" – that Turkish residents may be building up assets abroad. It is worth clarifying however that interpreting the build-up in F/X assets by banks abroad as such as "capital flight", is simply and technically wrong. For one thing, the build-up in banking sector F/X reserves is driven by a myriad of factors (since BOP is a double-entry system), but more importantly, "capital flight" – in a most typical case – would *reduce* banking sector reserve assets (not increase them), with a drawdown in sector's reserves financing an outflow by a resident – corporate or household. Since the asset build-up by this nonbank entity would show up in the BOP accounts with a lag at best (from the BIS data) or never at all, this would most likely appear as an outflow through the errors and omissions (E&O).

In Turkey's case, however, at least until recently, E&Os have been typically positive, and moving *inversely* with identified flows, at the margin, acting as a stabilizer or an equilibrator of sorts (see chart), i.e. when the times are tough, residents draw on their reserves abroad, and when times get better, these reserves are replenished.

But while capital flight may not be too much of a problem – at least as yet – a bigger problem is that Turkey in any event fails to receive enough inflows to finance the CAD. In the 12-month period through February, for instance, capital inflows have been running at a rather modest level of $20 billion or so, i.e. markedly below the levels required to finance the CAD (of $33 billion).

This is important, because unless this math changes for the better (with capital flows outpacing CAD), the lira cannot hold up without aggressive support from monetary policy, which means that the latter would be forced to stay tight -- no matter how (awkwardly) this "tightness" is executed in practice or how "temporary" it is desired to be (see our *More "Temporary" Tightening, As Expected*, March 16, 2017).



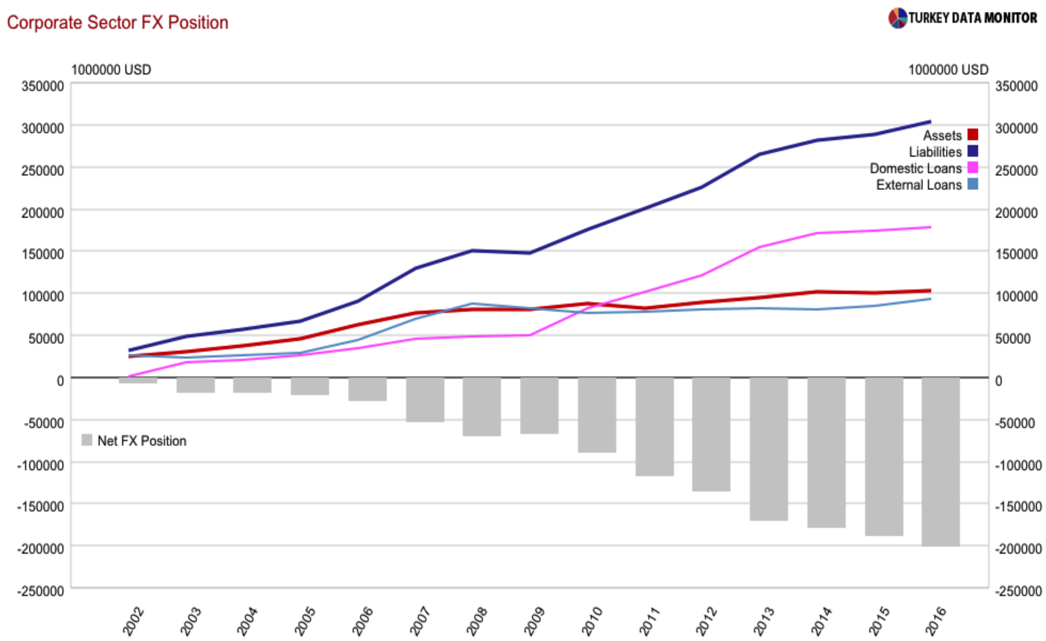
NFC F/X Position: A monitoring system reportedly to be launched soon

Since late last year, there has been some news about government working on a new corporate sector risk monitoring system, with a view to better identifying the non-financial corporates (NFC) with particularly high open F/X exposures. This week, there has been additional reporting on the issue (click here; article in Turkish), stating that this system may be finalized soon. During the week, Deputy PM Simsek also said that the system would initially focus on some 2000 NFCs that hold around 83% of the open F/X position in the system. The approach reportedly aims at a more careful monitoring of distressed firms with a view to asking them to introduce measures (like provisioning for potential losses) gradually and on a case-by-case basis.

How exactly this would play out and in what time frame is unclear, but the initiative is very welcome yet way overdue. This is an issue that the analyst community (including the IFIs, most notably the IMF) has been worried about for almost a decade now, during which the open position climbed from around $70 billion before the global crisis to around $200 billion, driven mainly by F/X loans lent *domestically* (see chart). True, the CBRT has done a few studies on the issue, basically dismissing its graveness, to argue that: a) the risk is primarily concentrated on a few large firms with “sound” financial positions and risk management practices (in fact, at some point we remember former Governor Basci, awkwardly enough, mentioning this as a “sign of strength” for the economy and the NFC sector); b) a good chunk of these positions are “naturally” hedged, and c) the F/X debt has relatively long-term maturity.

But with the lira having weakened by 80% since the days of “taper tantrum” (i.e. over the past 4 years), the economy slowing sharply since the latter part of last year, most of these firms, contrary to the CBRT’s rather complacent take, operating in construction and energy sectors with dubious F/X revenues, the NPL problem of the banking sector reportedly growing and finally, the lira still under pressure, the government now appears to have been compelled to take the issue more seriously, and identify the most problematic NFCs.

There is a catch, however. While the initiative should help to improve risk profile through more transparency, it is, *ceteris paribus*, likely to add to the pressures in the F/X market. At the end of the day, Turkey will continue running CADs and its net international investment position (NIIP) will worsen further, which means that the F/X risk will have to accumulate somewhere. But now we are saying, the main recipient of this risk thus far, the NFCs, can no longer do it.



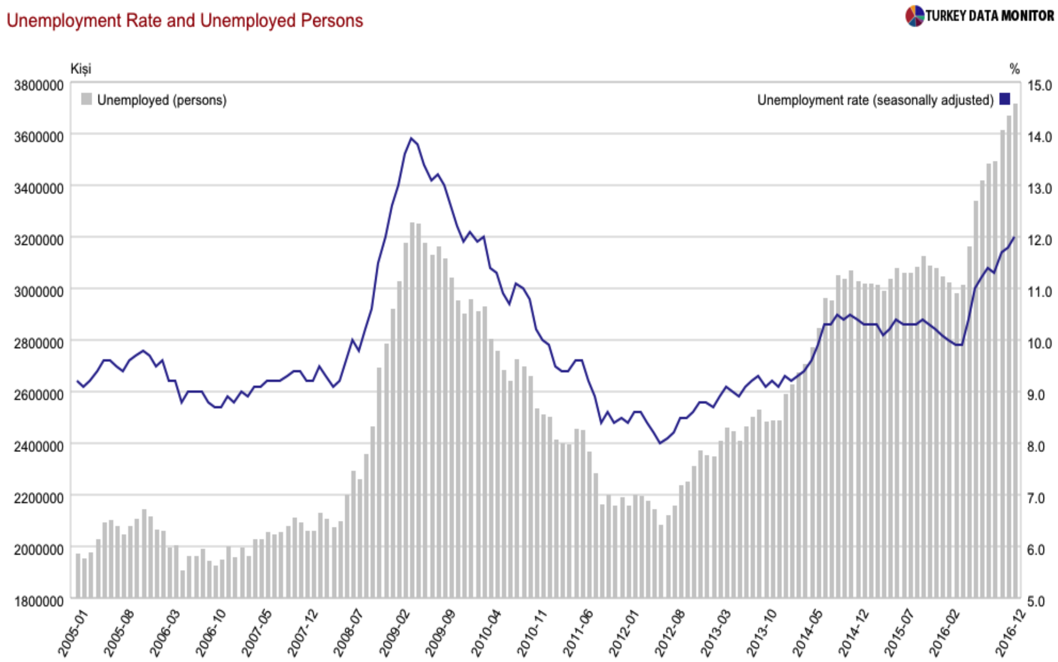
Unemployment is rising, expectations deteriorating

We've written a lot already, so let's keep it short on these two indicators, neither of which provides much comfort. On the unemployment front, we are now at 12% (in December), which is over 2 pps higher than the lows of 9.9% seen earlier last year. Aside from deteriorating percentages, the absolute number of unemployed is also rising fairly rapidly (see chart; table).

Labor Force and Employment: 2014-16
(in thousands)

	Dec 16	Dec 15	Difference 2016 / 2015	Difference 2015 / 2014
Population 15 Years of Age and Over	59,146	58,294	852	893
Labor Force	30,540	29,652	888	865
Employed	26,669	26,448	221	806
Agriculture	4,915	5,003	-88	-7
Industry	5,265	5,311	-46	45
Construction	1,836	1,878	-42	49
Service	14,652	14,256	396	719
Unemployed	3,872	3,204	668	59
Not in labour force	28,606	28,642	-36	28
Labor Force Participation Rate (%)	51.6	50.9	0.7	0.7
Unemployment Rate (%)	12.7	10.8	1.9	-0.1
Memorandum Item:				
Non-farm unemployment rate (%)	14.9	12.7	2.2	-0.2
Youth unemployment rate (%)	24.0	19.2	4.8	-1.0

Source: TURKSTAT; Turkey Data Monitor.

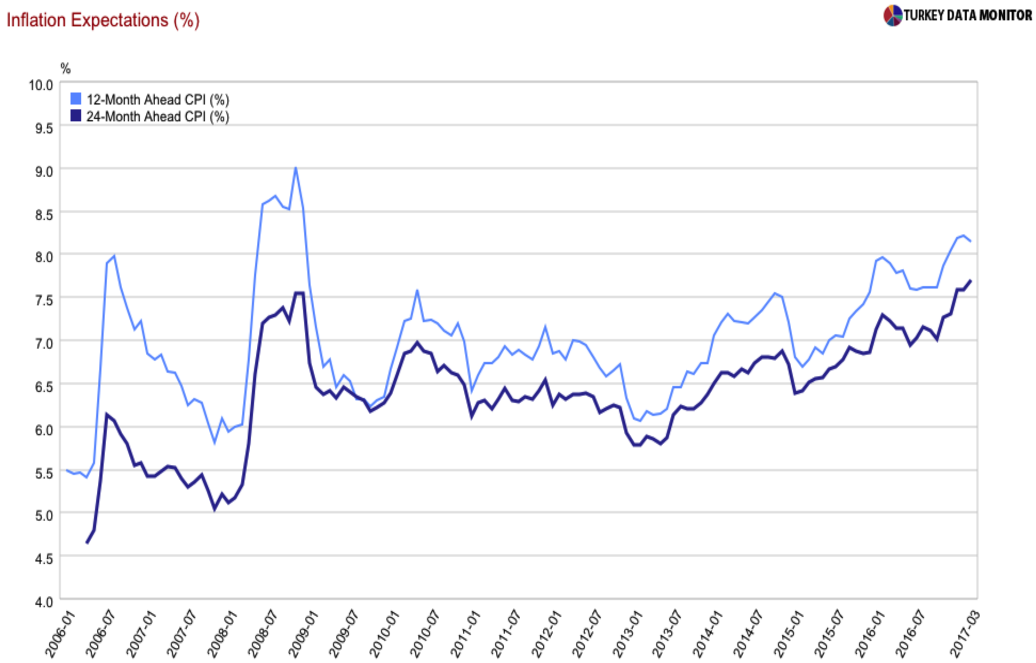


On the expectation front, the most notable development pertains to inflation expectations, which have, now at 7.7%, set a record on 24-month horizon. We find this quite disturbing in that, as the indicator that is suppose to be least responsive to the day-to-day news flows (or various shocks), it suggests a more fundamental deterioration in the pricing behavior or trend inflation, arguably a direct outcome of the convoluted ways the CBRT has been conducting monetary policy in the past several years (see chart; table).

CBRT Expectations Survey

	Dec-16	Jan-17	Feb-17	Mar-17
Monthly inflation (%)	0.79	1.44	0.62	0.68
Year-end inflation (%)	7.69	8.48	8.87	9.08
12-month ahead inflation (%)	8.04	8.19	8.21	8.15
24-month ahead inflation (%)	7.31	7.59	7.59	7.70
12-month ahead 5-year fixed coupon bond rate (comp.; %)	11.00	11.03	10.97	11.10
12-month ahead 10-year fixed coupon bond rate (comp.; %)	11.18	11.13	11.00	11.16
Expectation of Weighted Average Cost of the CBRT Funding ((	8.33	9.13	10.37	10.81
12 Month Ahead CBRT One-Week Repo Rate (%)(simple; %)	8.50	8.71	8.52	8.51
24 Month Ahead CBRT One-Week Repo Rate (%)(simple; %)	8.33	8.43	8.32	8.29
Year-End US$/TL exchange rate	3.46	3.86	3.88	3.85
12-month ahead US$/TL exchange rate	3.63	3.96	3.96	3.92
Year-end current account balance (bn US$)	-34.02	-35.40	-35.64	-35.81
Next year year-end current account balance (bn US$)	-36.84	-38.22	-37.87	-38.51
Year-end growth (%)	2.62	2.90	2.87	2.86
Next year year-end growth (%)	3.18	3.59	3.49	3.46

Source: CBRT



COSMIC STRATEGIST: ALL WELL, IF YOU CAN IGNORE POLITICS

Cosmic Strategist is very confused about the progress of the markets until the referendum, but crystal-clear, about what will happen thereafter. In the "short-run", He thinks a continuation of the bond and equity rallies has become the dominant theme, if investors can ignore political risks, which nowadays they tend to do most everywhere. After the referendum, regardless of the results, a heavy sell-off will ensue.

First, His Cosmicness is surprised by the sudden hawkishness of the CBRT, which continues to raise the effective funding rate. He thought with Dollar Index weak and global risk appetite shamelessly high for EM assets, the CBRT would raise the interest rate for Late Liquidity Window but would not avail itself of the opportunity to further hike the blended daily funding rate. On Friday, it just did so. As He is wont to, Cosmo suspects ulterior motives:

- CBRT might have been informed of the Moody's outlook downgrade before the public announcement,
- As alluded to in the CBRT MPC statement, the inflation outlook in the near term could be more dire than most of us imagine,
- As CBRT collects data on the F/X debt of corporates, it might have reached the conclusion that resilience to a weaker currency is collapsing, hence the need to keep rates high (see relevant discussions above).

No matter what the reason might be, Cosmo now believes regardless of the trend of the Dollar Index and the inflows into EM assets, particularly Turkey, the CBRT will stick to its promise of high rates until the referendum, possibly higher. With Turkey paying one of the highest nominal rates among EMs, it should attract enough financial capital to steady the currency, while the incentive for domestics to switch to F/X is lessened.

The main risk for a currency collapse until the referendum is unforeseen political events in Syria or at the EU front or very concrete evidence that AKP might be losing the vote. Cosmo underlines three possibilities:

- Ankara ordering the Army into one of the three Syrian Kurdish cantons.
- An official agreement to abrogate the Refugee Readmission Treaty.
- A series of polls revealing YES votes are falling behind (Cosmo thinks investors would sell an AKP defeat, because at the very least it would precipitate early elections).

In as much as AKP's predictability is at par with Mr. Trump nowadays, Cosmo considers all the three eventualities above as tail-risks, hence His confidence about a solid market performance until the referendum.

SELECTED MARKET INDICATORS

			% Change				
	17-Mar	10-Mar	Weekly	Monthly	3-Month	Year-to-Date	Annual
Treasury Benchmark Rate (compounded;%) 1/	11.56	11.48	0.08	-11.39	-10.89	-10.65	-10.30
CBRT One-Week Repo Rate (simple %) 1/	8.00	8.00	0.00	0.00	0.00	0.00	0.50
CBRT Funding Rate (%)	11.29	10.82	0.47	0.91	3.01	2.98	2.36
BIST Repo/Reverse Repo Interest Rate(%) 1/	10.79	10.64	0.15	0.67	2.88	2.47	0.48
Exchange Rate Basket (0.5$+0.5€)	3.75	3.86	-3.01	-1.11	4.74	3.57	23.08
USD/TL	3.609	3.750	-3.75	-1.65	3.18	2.46	26.26
EUR/TL	3.885	3.976	-2.31	-0.61	6.23	4.62	20.26
BIST 100 (TL, close)	90,491	89,611	0.98	1.87	17.28	15.81	11.20
BIST 100 (US cents)	2.46	2.39	2.79	3.58	13.67	10.73	-11.93
BIST Trading Volume (billion TL) 2/	4.8	4.0	19.44	13.80	27.07	119.06	15.41
MSCI TR Index 2/	356.0	343.3	3.69	3.28	12.49	12.56	-9.65

1/ % change columns are differences in basis points for the corresponding periods. Benchmark paper as of Jul 13th is Jul 11, 2018.
2/ Latest data:March 16

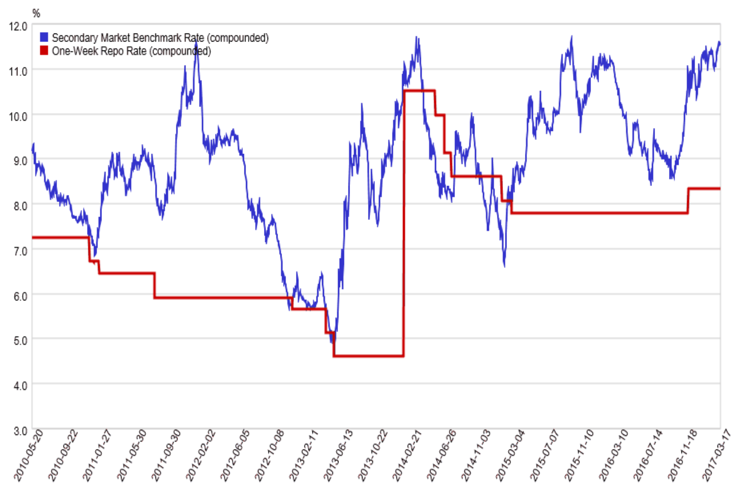
DATA RELEASE AND EVENT CALENDAR: MARCH 20-24

20	Central Government Debt Stock (Feb-17)	Jan-17 Central Government Debt Stock: TL800.2
	Non-Domestic PPI (Feb-17)	Jan-17: Non-Domestic PPI (yoy): 24.3%
23	TURKSTAT Consumer Confidence Index (Mar-17)	Feb-17 Consumer Confidence: 65.7
	Labor Statistics (2016)	2015: Unemployment Rate: 10.3%
24	Home Sales (Feb-17)	Jan-17: Total Home Sales (yoy): 12.8%

SELECTED FINANCIAL AND MARKET DATA

Secondary Market Benchmark and One Week Repo Rate

TURKEY DATA MONITOR

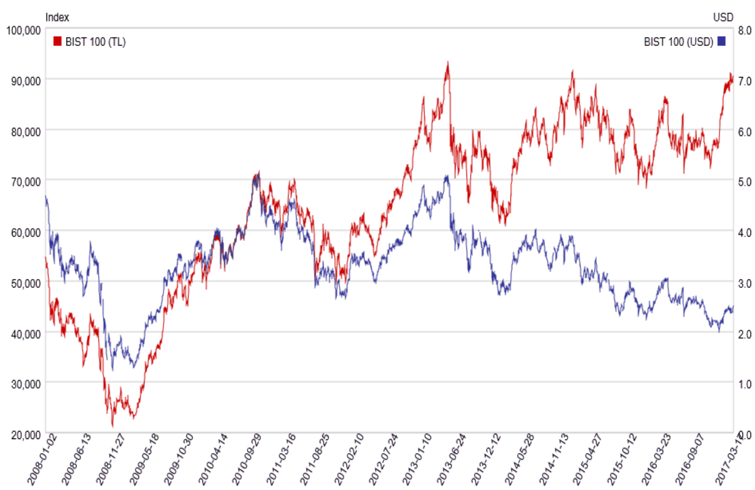


Nominal Exchange Rates

TURKEY DATA MONITOR

Borsa Istanbul

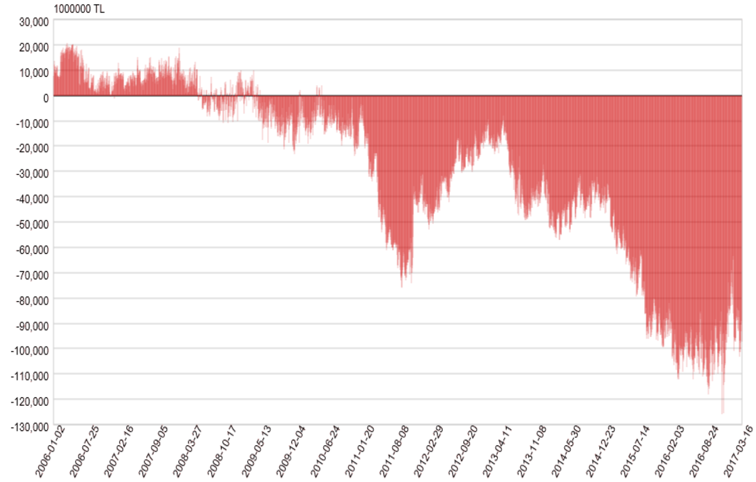
TURKEY DATA MONITOR



SELECTED FINANCIAL AND MARKET DATA (CONTINUED)

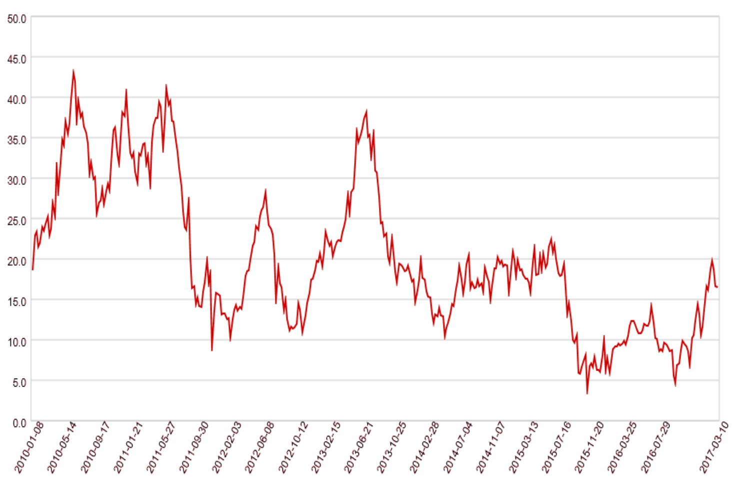
Open Market Operations (million TL)

TURKEY DATA MONITOR



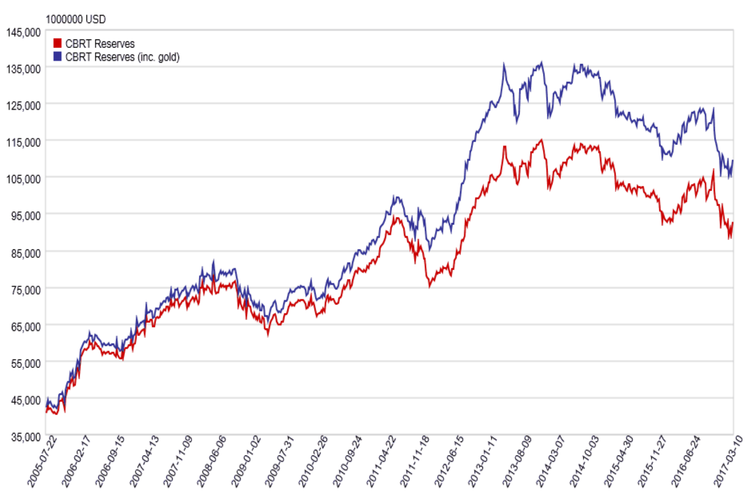
Total Credits (13-week moving average, annualized, FX adjusted)

TURKEY DATA MONITOR

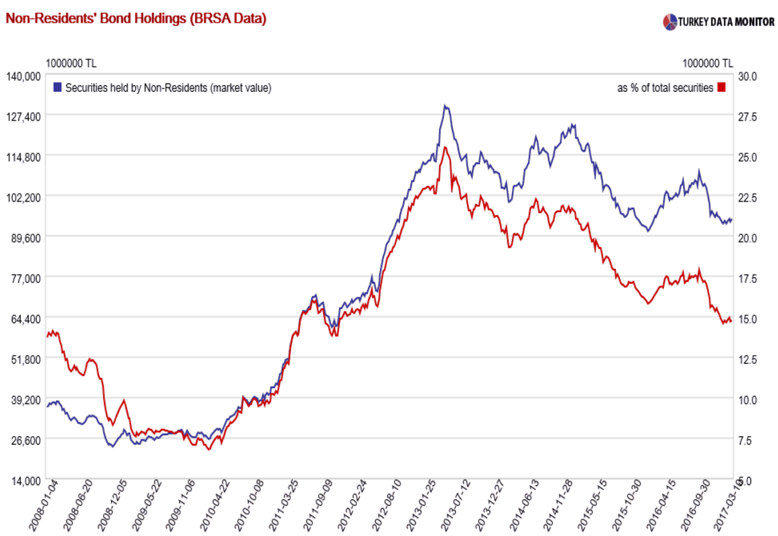


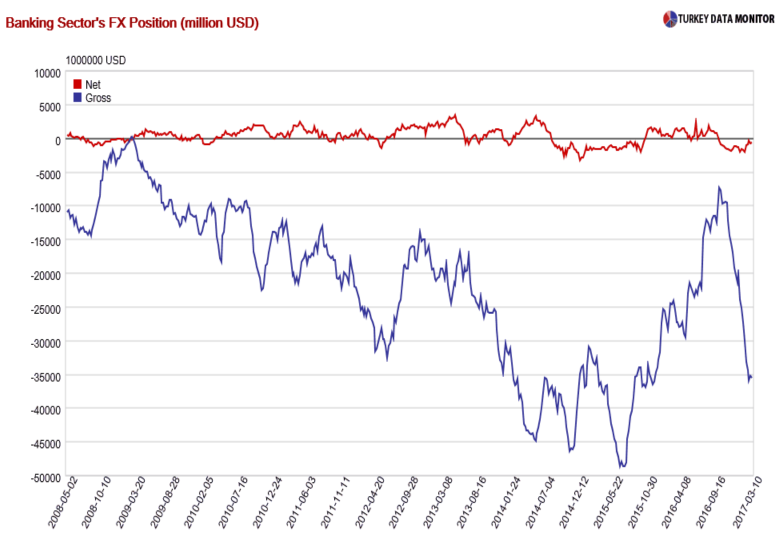
CBRT Reserves (million USD)

TURKEY DATA MONITOR



SELECTED FINANCIAL AND MARKET DATA (CONCLUDED)





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