



## Macro Scope

26 July – 1 August 2010

# Weekly Economic and Strategic Review

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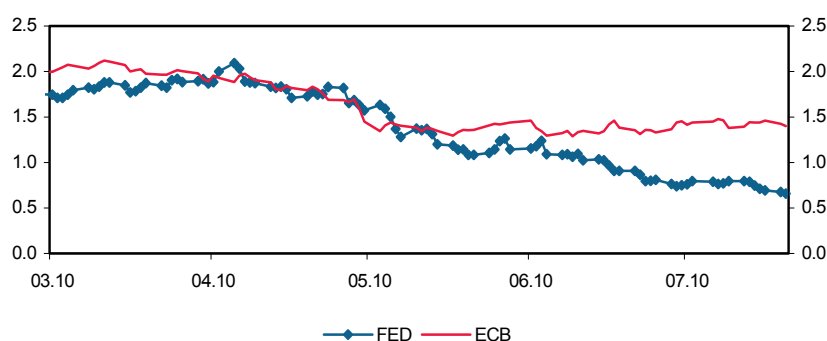
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## Slow and Low...

The data disclosures in the week behind did not change the outlook much but stressed more loudly that the economies across the World is heading towards a period of slowdown. In these circumstances, monetary policies seem to be obliged to shoulder the responsibility of stimulating economic activity, given the fact that the governments have depleted the fiscal tools so far and pushed their budgets to limits in the last years.

This backdrop reinforces the expectations that the interest rates would have to surface at low levels for a longer period of time. In US, the rate hike forecasts are now postponed to even late 2011, while the focus seems to be on the alternative monetary solutions, other than the already dipped interest rates, to buttress the faltering economic recovery. Based on the Fed Funds futures, Fed is priced to introduce 50-75 bps hike by the end of 2011. This means more than 100 bps decline compared to the market valuations before May. The futures market for the 3-month Euribor rates allows for a similar analysis for the ECB. We reckon that the markets anticipate the ECB to raise the rates by around a mere 50 bps by the end of 2011.

2011 End-year Interest Rate Expectations In The Futures Market (\*)

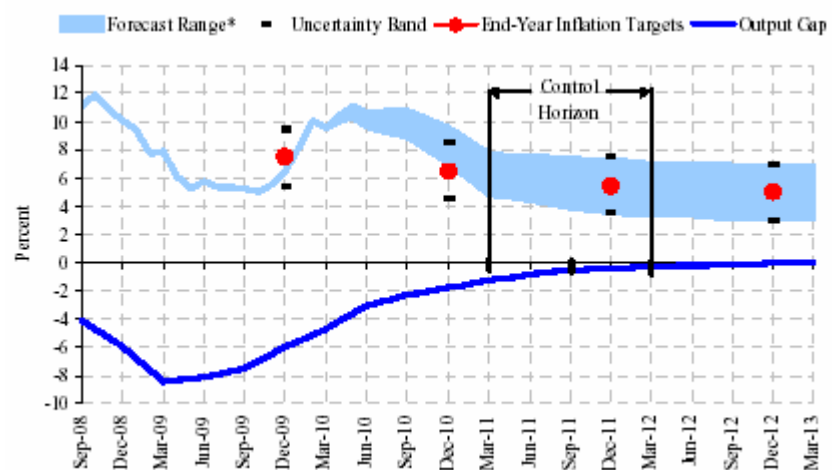


(\*) Expectations for the Fed rate are estimated via futures transactions in CBOE and expectations for the ECB rate are the 3-month Euribor rate estimated via futures transactions in Liffe.

The outlook in the developed countries will be one of the key determinants of the interest rate outlook in the developing universe. A sustainable recovery in the latter would be possible with stronger economic data in developed countries which would let their central banks resume exiting the easy monetary policies. Moreover, early rate hikes in developing countries would result in currency appreciation, hindering recovery in economic activity via diminished competitiveness in foreign trade. Therefore, the current outlook in the developed countries seems to delay the interest rate hikes across the globe.

No surprise, the CBRT has recently changed their stance on monetary policy, as well. The weakening signals in economic data, together with the improving inflation outlook seem to have urged the Bank to postpone the interest rate hikes to a later date than planned in the April Inflation Report. Recall that in the April Inflation Report the Bank had described their monetary policy stance in the baseline scenario as follows: "... policy rates are kept constant at current levels for sometime followed by limited increases starting in the last quarter of 2010, with policy rates staying at single digits throughout the three-year forecast horizon..." This plan needed to be terminated shortly after, due the developments in the EU, signals as to the weakening of economic activity at home and across the globe, as well as the benign inflation outlook. Therefore, coming to May, MPC statement again mentioned of keeping the interest rates at current levels for some more time, meaning that the Bank preferred to be less certain about the monetary policy decisions with an increased data dependency. However, keeping the wording as it is even after three months makes us to think that the beginning of the rate hikes is already delayed further. Otherwise, the Bank should have changed the wording of "sometime" with a new one pointing for a nearer future such as "short period of time," since we are getting closer to the Bank's previously planned timing for rate hikes.

#### The Central Bank Forecasts For Inflation and Output Gap



(\*) The shaded region indicates the 70% confidence interval for the forecast.

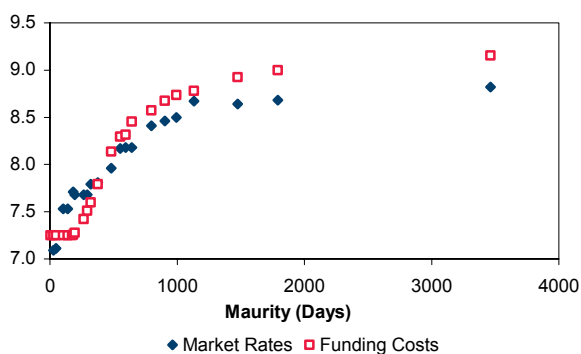
Source: CBRT, April Inflation Report

We anticipate the Bank clarifying these points in the Inflation Report due to be released on July 27<sup>th</sup>. The Bank's inflation forecasts will also be benchmark in that respect. As shall be recalled, the year-end forecasts for 2010 and 2011 were 8.4% and 5.4% in the previous report. Back then, the Bank had foreseen that the price increase in oil and food would have added some 0.15 pp and 0.55 pp to the headline CPI, respectively, while the improved growth outlook added some 0.4 pp. **Now that these impacts are reversed, there seems to be room for the 2010 year-end forecast being revised down to 7.0-7.5% interval.** More importantly, some 1.9 pp contribution of the tax hikes in alcoholic beverages and tobacco to the 2010 CPI would be erased in January next year. To put it differently, **these CPI levels for 2010 would imply a much lower CPI at around 5.0-5.5% right at the beginning of next year.** Nevertheless, we believe the revisions to the Bank's forecasts for 2011 and after would remain limited. Rather than lowering these forecasts, the Bank would push forward the timing of the rate hikes to a later date than the last quarter of this year which had been the Bank's original plan. The Bank is likely to be more specific on the timing, for instance by hinting at the beginning of next year, rather than a vague rhetoric as was used in the last MPC meeting.

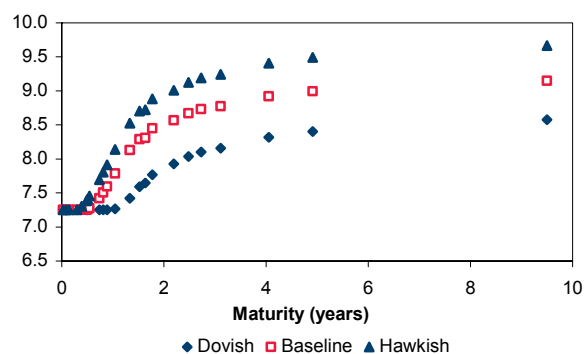
This outlook seems to be in line with the market rates. In order to analyze the market valuations, we compared the discount and fixed-coupon bond yields with

the funding cost based on our policy rate forecasts. **In the most likely scenario, which we believe would pretty much overlap with the Central Bank's own assumptions, the Bank starts hiking in early 2011 with 25 bps hikes at each meeting and the policy rate stabilizes at 9.0% in the second half of the year. We calculated the banks' average funding cost (calculated via the 1-week repo funding rate) at all bond maturities under this scenario and provided a comparative graph with the current market yields as of July 22<sup>nd</sup>.** As can be seen, the yields of the bonds tagged with maturities of 2 to 5 years are even below the funding cost, i.e. they are quite expensive with these funding forecasts.

**Bond Market Yield Curve and Funding Costs (%)**



**Policy Rate Scenarios and Estimated Funding Costs (%)**



*Dovish: Rate hikes start in 2H 2011, with an overall increase of 150 bps.*

*Baseline: Rate hikes start in the beginning of 2011, they are gradual and reach 200 bps.*

*Hawkish: Rate Hikes Start in 4Q 2010, with an overall increase of 250 bps.*

However, depending on the Central Bank's tone, a more dovish scenario may become valid as well. For instance, let's suppose that the rate hikes start at the second half of 2011 and reach a cumulative 150 bps. In that case, the funding cost for the 10-year bond would be 8.6%, indicating some 25 bps discount from the current valuations. This scenario offers a profit of around 30 bps and 50 bps for 5-year and 1-2 year bonds respectively, while the funding cost for the benchmark bond is 7.8%, which is the lower boundary that its yield can drop under these assumptions.

Summing it up, decelerating economic activity has become the base case scenario across the globe, with the extent of slowdown differing among countries. This baseline scenario paves the way for a monetary policy change led by the developed countries' central banks and the rate hikes seem to be delayed to the second half of 2011. For Turkey, the tightening may not be delayed that much, given the fact that the initial monetary easing was much larger at the crisis period, the growth remains at a stronger path and there are some glitches in the structural reform process, as evident in the delay of fiscal rule. Nevertheless, we do not expect to see tightening earlier than the beginning of 2011 and the tightening process would presumably evolve very slowly. The Central Bank will say the last word and their strategy to be declared in the Inflation Report due July 27<sup>th</sup> will be critical in shaping the expectations in the short term.

## Economic and Political Agenda

At home, signals regarding the July economic activity will be available with the disclosure of the leading indicators such as capacity use and Real Sector Confidence Index due Monday. Furthermore, Inflation Report that will be released on Tuesday is critical in terms of interest rate outlook. Besides, Treasury will hold three different auctions on Monday and Tuesday for TRY 6 bln debt service. At abroad, Eurozone has a relatively light schedule while the US data flow will be loaded. As 2Q advanced GDP, new home sales and durable good orders are going to be among the most critical data in the US, consumer confidence index and Chicago PMI will be the early indicators for July. In addition, there are more company balance sheets in the pipeline this week but the most critical ones, especially the banks, were left behind.

### Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis (Consensus)
Medium	Capacity Use, July	%	July 26 <sup>th</sup> , 13:30 GMT	(73.1)
High	Real Sector Confid. Index, July	-	July 26 <sup>th</sup> , 13:30 GMT	-
High	Inflation Report III	-	July 27 <sup>th</sup> , 7:00 GMT	-
High	Imports & Exports, June	US\$ bln	July 30 <sup>th</sup> , 7:00 GMT	15.4 & 9.2

### Data issuances Abroad

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
High	U.S.	New Home Sales, June	mln	July 26 <sup>th</sup> , 14:00 GMT	0.32
Medium	U.S.	C. Shiller Hous. Price Ind., May	% m/m	July 27 <sup>th</sup> , 13:00 GMT	0.0
Medium	U.S.	Cons. Conf. Index, July	-	July 27 <sup>th</sup> , 14:00 GMT	52.8
Medium	U.S.	Factory Orders, June	% m/m	July 28 <sup>th</sup> , 12:30 GMT	0.2
Medium	U.S.	Durable Goods Orders, June	% m/m	July 28 <sup>th</sup> , 12:30 GMT	0.7
High	U.S.	GDP (adv.), 2Q	% q/q	July 30 <sup>th</sup> , 12:30 GMT	3.0
Medium	U.S.	Chicago PMI, July	-	July 30 <sup>th</sup> , 13:45 GMT	57.5
High	U.S.	Michigan Sentiment Ind., July	-	July 30 <sup>th</sup> , 13:55 GMT	66.5

## Macro-Economic and Financial Forecasts

### Macro Economic Outlook of 2009-2012

	2009	2010f	2011f	2012f
<b>GDP (TRY - bn)</b>	954.0	1,095.5	1,203.7	1,317.6
<b>GDP (US\$ - bn)</b>	616.6	716.0	779.1	839.3
<b>GDP Growth (y/y % chg)</b>	-4.7	7.0	4.0	4.0
<b>PPI (y/y % chg)</b>	5.9	5.0	5.0	5.0
<b>CPI (y/y % chg)</b>	6.5	7.2	6.0	5.5
<b>Trade Balance (US\$ - bn)</b>	-38.6	-64.2	-72.9	-74.2
Exports (FOB, excl. luggage trade)	102.2	103.3	117.8	140.1
Imports (CIF, incl. gold)	140.8	167.6	190.8	214.3
<b>Current Account Balance (US\$ - bn)</b>	-13.8	-37.1	-42.5	-40.6
<b>Current Account Balance / GDP (%)</b>	-2.2	-5.2	-5.5	-4.8

### Financial Indicators Forecasts

	July 23 <sup>rd</sup>	1M	3M	6M	12M	2010	2011
<b>US\$/TRY</b>	1.5177	1.5500	1.5500	1.5400	1.5500	1.5500	1.5600
<b>EUR/TRY</b>	1.9478	1.9800	1.9700	1.9700	2.0400	1.9700	2.1100
<b>FX Basket</b>	3.4655	3.5300	3.5200	3.5100	3.5900	3.5200	3.6700
<b>EUR/US\$</b>	1.2834	1.2800	1.2700	1.2800	1.3200	1.2700	1.3500
<b>Policy Rate</b>	7.00%	7.00%	7.00%	7.00%	8.00%	7.00%	9.00%
<b>Benchmark Bond</b>	8.20%	8.30%	8.70%	9.50%	10.30%	9.20%	11.00%

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