

FORTIS BANK

Macro Scope

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Weekly Economic and Strategic Review

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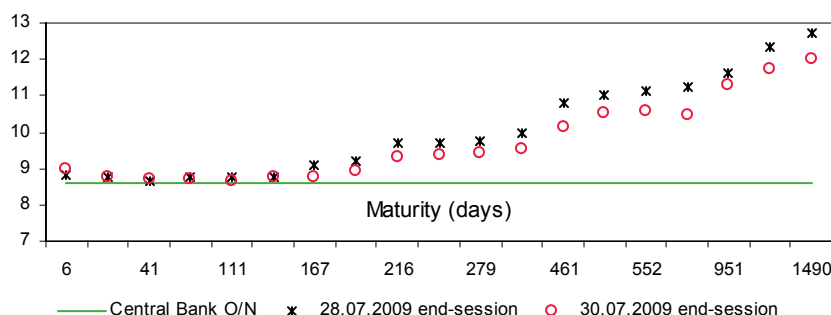
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Single, But Happy?...

Since the global economies left the worst of the crisis behind and entered into the recovery phase, the central banks across the globe have not only started to feel obliged to share their exit strategies from the aggressive conventional and unconventional monetary easing policies, but also they have been confronted with the difficulty of managing this process without ruining the economic recovery. The markets, who always tend to price the future, acknowledge that the current outlook is not sustainable and given the record wide budget deficits, they believe that the inflation would pick up once the recovery gains steam, eventually urging for tighter monetary policies. Therefore, the markets are hardly convinced for lower long term interest rates, where the short term policy rates have limited power of influence. That is why, we have been highlighting for some time that the most critical indicator in the period ahead would be 10-year U.S. Treasury yields, rather than stock market indices. The potential impact of sizeable changes in the 10-year Treasury yields on market movements should not be underestimated. Fed was the first central bank to unveil the exit strategy. Fed Chairman Bernanke stated that they have the necessary tools to draw back the excess liquidity, noting that it is yet early for such an operation and that the monetary policy is to remain accommodative for an extended period. Despite these statements, the Fed fund futures keep pricing that the Fed rate would reach 1.75% by the end of 2010 from the current 0.25%. Moreover, the 10-year U.S. yield continues trading at 3.70%, which is quite high for a recessionary environment. Apparently, it turns to be hard to convince the market players. A similar problem is also valid in Turkey. As you can find the details in our *MacroBrief* report released within the week, the Central Bank provided short, medium and long term perspectives for the policy rates with an attempt to bring the market yields more aligned with future policy intentions. Yet, note that while outlining this perspective, the Central Bank presumes the global interest rates to remain low for an extended period of time.

Bond Market Yield Curve



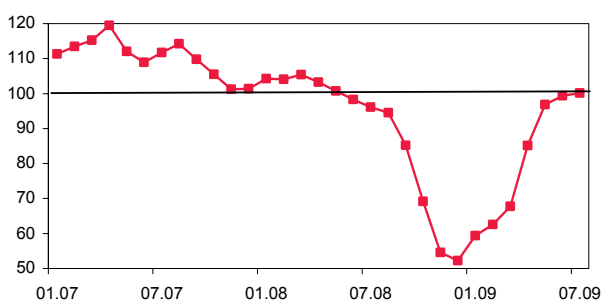
Source: Istanbul Stock Exchange, Fortis Economic Research and Strategy

Therefore, if the U.S. Treasuries start pricing an early exit even though Fed does not have such a plan, that may pose a major risk against the Turkish Central Bank's intention to keep the interest rates constant until end-2010.

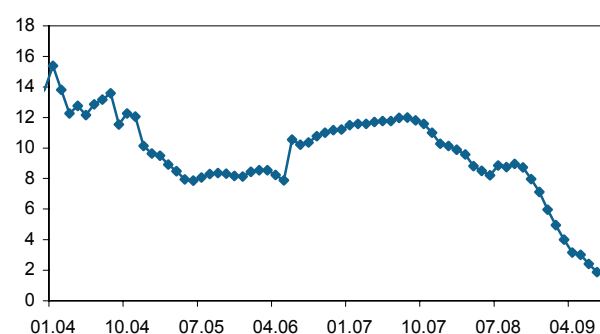
After the CBT's Inflation Report, the yield curve started to flatten visibly. Therefore, the Bank seems to have a high chance of being successful in influencing the expectations. The yield curve flattened as the yields at the long end of the curve dropped more visibly. The O/N correspondence of the end-2010 maturities were some 215 higher than the Central Bank's O/N rate prior to the Inflation Report, before declining to 160 bps in today's session.

However, we find the Central Bank quite assertive for claiming that *“the establishment of a credible medium-term program should make it possible to keep longer-term rates at single digit levels.”* The output gap that is assumed to approach 9% by the Central Bank may seem to create an appropriate environment for very low nominal and real interest rates. Yet, even if the interest rates fell to single digit levels, they would hardly remain there as the output gap eventually starts to narrow. In Brazil, where the inflation hovers at a range of 4-5% even under normal circumstances, the 3-year bond yields did not ever regress below 10%. On the other hand, the yields of similar-maturity bonds in Hungary and South Africa, which are regarded as peer countries for Turkey, surfaced at 8-9% range for a considerable period. Among these countries, whose credit ratings are a few-grade above Turkey, Hungary has a higher CDS than Turkey, but their interest rate is surfacing at single-digit levels. This comparison seems to have encouraged the Central Bank for a potential decline in the Turkish yields to single digit if the conditions support. **Once the economy leaves the recession behind and improves towards potential growth, total demand conditions would not be as supportive for the low interest rates and achieving a persistent decline in inflation to the 4-5% range would be the major determinant of whether interest rates would surface at single-digit levels.** If inflation can be limited as such, in the best case scenario, the yields may decline to single digit, with 300 bps country risk and some 2-3% real interest rate – this is the real interest rate level in developed countries under normal circumstances. On the other hand, if there appears a worse outlook than the gradual recovery, which is the baseline scenario for us and the Central Bank, **single-digit interest rates to appear due to the extended weakness in economy would by no means be appreciated as a successful policy outcome.**

Real Sector Confidence Index



Central Bank Real Policy Rate



Apparently, the timing of the exit from the loose monetary policies will depend on the strength of the recovery in the economic activity. In that context, the fresh data flow is supportive for the low level of interest rates. **The Real Sector Confidence Index, the major leading indicator for the economic activity, visibly cut pace in June and July, after depicting steep gains in the first months of the initial recovery.** The sub-indices for the next 3-month output and export orders slid in the last two months, highlighting the downward risks on the strength of recovery going forward. Glancing at the fresh hard data, the automotive sales in July was only half of June, hit by the partial termination of tax cuts and was lower than the same month of last year. Moreover, exports kept

declining annually in July, regressing sharply by around 30%. Accordingly, the hard data also supports the case for lower rates.

All in all, after being encouraged by their success in the aggressive monetary easing, the Central Bank has turned more ambitious regarding the expectation management. Accordingly, the Central Bank has taken an important risk for lowering the market rates (bond yields and commercial loan rates), where the monetary policy has a limited influence. Even though the baseline scenario that the policy rates will remain constant until end-2010 and the market rates will surface at one-digit levels for a considerable time seems possible for the short term in the current economic backdrop, there are also a series of assumptions that has a lower chance to come true in the longer term.

Economic and Political Agenda

▪ The markets will focus on inflation at home to be released on Monday. Meanwhile, we reckon that the first important redemption in the Treasury's borrowing program, which was not unveiled at the time we were writing this report, will be TRY14.1bn on August 5th. In the external arena, while U.S. non-farm payrolls will be critical, Eurozone and U.S. PMIs will be on the forefront, as well. Separately, the BoE and ECB will unveil their rate decisions this week. In the meantime, the balance sheet disclosures will continue topping the agenda.

Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis (Consensus)
Medium	CBNC-e Cons. Confid. Index, July	-	Aug. 3 rd , 6:00 GMT	-
High	CPI, July	%m/m	Aug. 3 rd , 14:00 GMT	0.3 (0.22)
High	PPI, July	%m/m	Aug. 3 rd , 14:00 GMT	(-0.01)
High	CB's Expectation Survey, Aug.I	-	Aug. 7 th	-

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
High	Eurozone	Manufacturing PMI, July	-	Aug. 3 rd , 7:58 GMT	46.0
High	U.S.	Manufacturing ISM, July	-	Aug. 3 rd , 14:00 GMT	46.2
High	U.S.	Core PCE, June	% m/m	Aug. 4 th , 12:30 GMT	0.2
Medium	U.S.	Pending Home Sales, June	% m/m	Aug. 4 th , 14:00 GMT	0.2
High	Eurozone	Services PMI, July	-	Aug. 5 th , 7:58 GMT	45.6
Medium	U.S.	ADP Employment, July	K	Aug. 5 th , 12:15 GMT	-340
High	U.S.	Non-manufacturing ISM, July	-	Aug. 5 th , 14:00 GMT	48.2
High	U.K.	BoE Rate Decision	bps	Aug. 6 th , 11:00 GMT	no chg.
High	Eurozone	ECB Rate Decision	bps	Aug. 6 th , 11:45 GMT	no chg.
High	U.S.	Non-farm Payrolls, July	K	Aug. 7 th , 12:30 GMT	-340
High	U.S.	Unemployment, July	%	Aug. 7 th , 12:30 GMT	9.7

Macro-Economic and Financial Forecasts

Macro Economic Outlook of 2007-2010

	2008	2009f	2010f	2011f
GDP (TRY - mn)	950.1	933.8	1,024.6	1,132.9
GDP (US\$ - bn)	734.9	591.0	637.9	689.4
GDP Growth (y/y % chg)	1.1	-5.5	4.0	5.0
PPI (y/y % chg)	8.1	4.0	5.0	4.0
CPI (y/y % chg)	10.1	5.5	6.5	5.5
Trade Balance (US\$ - bn)	-69.8	-39.1	-62.6	-68.3
Exports (FOB, excl. luggage trade)	132.0	98.1	98.4	106.1
Imports (CIF, incl. gold)	201.7	137.2	161.0	174.4
Current Account Balance (US\$ - bn)	-41.5	-12.8	-33.6	-36.3
Current Account Balance / GDP (%)	-5.7	-2.2	-5.3	-5.3

Financial Indicators Forecasts

	July 31 st	1M	3M	6M	12M	2009	2010
US\$/TRY	1.4770	1.4650	1.5000	1.5200	1.5800	1.5000	1.5800
EUR/TRY	2.0778	2.0800	2.1000	2.1000	2.0900	2.1000	2.0500
FX Basket	3.5548	3.5450	3.6000	3.6200	3.6700	3.6000	3.6300
EUR/US\$	1.4068	1.4200	1.4000	1.3800	1.3200	1.4000	1.3000
O/N	8.25%	7.75%	7.25%	7.25%	7.75%	7.25%	10.00%
Benchmark Bond	10.50%	10.00%	10.50%	10.50%	12.00%	10.50%	12.50%

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