January 2017

By Lucas Irisik,
Assistant Portfolio
Manager/Senior Analyst

Nikko Asset Management

TURKEY ON A KNIFE'S EDGE

Last year, following the failed coup attempt and the subsequent purge of the Gulenist movement by Erdogan's AK Party, we produced a report, which highlighted the key risk for the Turkish economy and the path that policy makers were likely to take. The majority of adverse scenarios, both from the asset price and domestic policy perspective, have materialised. Given the importance of Turkey as an investable market for international investors, we felt that an update on the latest developments was due. In this report, we put special emphasis on domestic financial stability, and the banking sector in particular, in light of Turkey's deteriorating fundamentals.

Domestic macroeconomic picture remains vulnerable

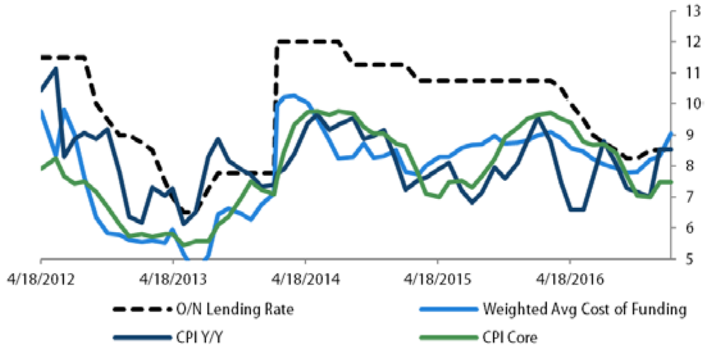
Growth momentum is showing signs of strain

The latest available data showed the economy contracting by as much as 1.8%y/y in the third quarter of 2016, driven by a weaker performance in household spending, exports and fixed investment, all of which fell in annual terms. The only bright spot was public spending, which jumped by 24%, preventing an even larger contraction in GDP. This, however, will deteriorate the fiscal position, which until now was the key strength of Turkey's economy.

Going forward, one can reasonably assume that security concerns, stemming from the bloody terrorist activity on Turkish soil, and the on-going political uncertainty in light of Erdogan's attempt to legitimise his de facto executive presidency, will enfeeble fixed investments, consumer spending and tourism arrivals even further. As such, the government's projections of growth rates reaching the magnitude of 4-5% in the forthcoming years appear wholly unrealistic. Given the current situation, the market consensus looks for a growth rate below 2% for the coming year, which for an economy that has a relatively young and fast growing population, is inadequate.

Price developments

CPI vs. Effective Funding Rate

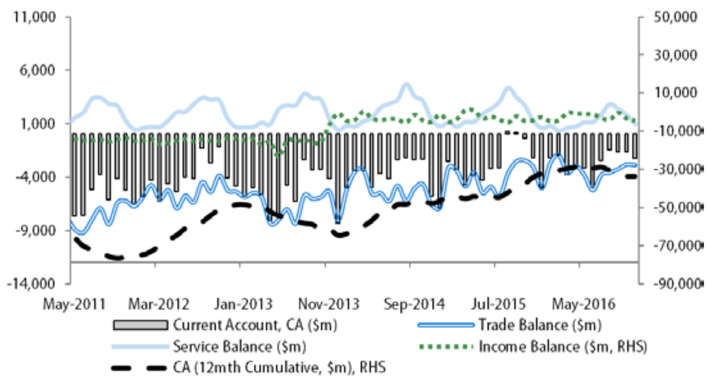


Source: Bloomberg

In our previous piece, we highlighted the risk of inflation moving higher on the back of a potential underperformance of the Lira. The Lira has lost as much as 30% versus the US dollar (at the time of writing) and the weakening trend has recently intensified, following the Central Bank of Turkey's (CBRT) reluctance to implement meaningful tightening measures to stem the decline. At this stage, it is fair to say that markets have realised that the authorities have yet again failed to learn from the past, committing a policy error by keeping monetary conditions too accommodative (CPI inflation has recently surpassed the weighted average cost of funding – effective policy rate). This, together with rising global oil prices, has already resulted in a notable reacceleration in both headline and core inflation measures. If unaddressed, the risk of de-anchoring could occur sooner rather than later.

Current account deficit

Balance of Payments

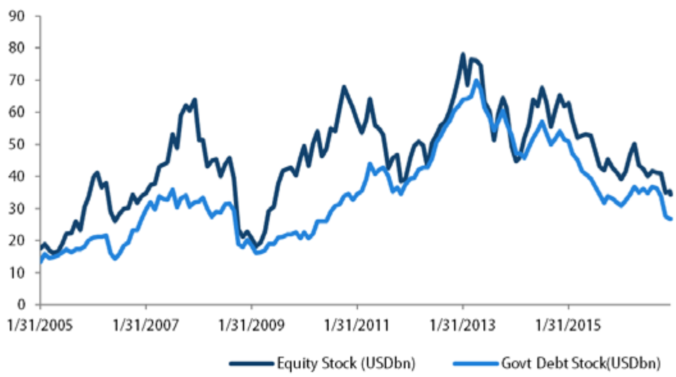


Source: Bloomberg

A higher oil price, accompanied by subdued tourist arrivals and, until now, a weak substitution effect away from costlier imports, has caused some deterioration in the current account deficit (CAD) in the past few months. As of October, the 12-month rolling CAD stood at USD33.65bn, which translates into slightly more than 4% of GDP. The deterioration has been driven by weak revenues from tourism (the effect of the previous Russian ban on travel to Turkey), as well as stronger than expected gold imports. Nevertheless, the pace of the CAD expansion so far, has been relatively subdued and given waning economic activity, and in turn, sluggish domestic consumption, there is little reason to expect the pace to increase meaningfully in the near term. On the one hand, the weakness in domestic consumption, coupled with a much weaker Lira, and the potential pick up in import substitution, could restrain the CAD expansion. Against this, security concerns related to geopolitical issues will continue to put downward pressure on tourism receipts via softer service balance.

Financing of External Imbalances

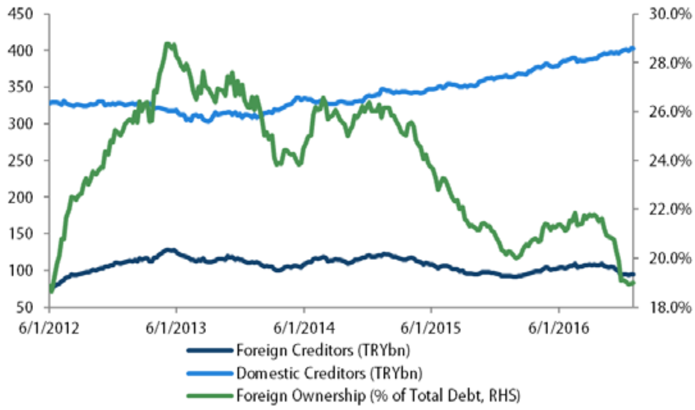
Non-Resident Holdings (USDbn)



Source: CBRT

The ongoing political and security concerns have led international investors to shy away from Turkish assets in recent months, as expected. The decline in foreign ownership of bonds was particularly significant, with the latest figures showing a mere 19% of the total government debt stock being in the hands of foreign creditors, from as high as 29% in 2013. As for equities, nearly 70% of shares that are traded daily on the Istanbul Exchange are still held by foreigners. The potential for further outflows could see this relative ownership decline, adding to market volatility.

Government Domestic Debt Holdings by Creditor



Source: CBRT

Like many developing nations, Turkey's equity market is subject to high volatility. This in itself does not necessarily pose a significant risk to the banking industry, despite a high proportion of foreign ownership, as Turkish banks usually do not invest into equities and no margin lending is offered to the banks' clients. This, however, does not mean that large portfolio flows (being either debt or equity related) do not pose an indirect threat to the banking sector. Rapid inflows or outflows are often associated with elevated currency or interest rate volatility; this at times can, however, be particularly costly.

It is apparent that financing the CAD has become much more vulnerable to shifts in global risk appetite as the absence of reliable portfolio flows of late has necessitated that the burden of financing the shortfall between domestic savings and investments falls largely on short-term wholesale funding, predominantly from European banks. Up to now, Turkish banks and corporates faced no difficulty in covering their external borrowing needs, and their debt rollover ratios were consistently close to or above 100%. In the current environment of higher global interest rates, slower domestic economic activity and elevated political concerns, investors will likely stay on high alert as the risk of a sudden stop of capital has reached levels not seen in years. If this were to happen the ramifications for corporates/banks operating domestically, particularly from the systemic risk standpoint, could be very severe, should negative risk sentiment lead to financial contagion concerns, with other major emerging markets that heavily rely on "fast money" to cover their external imbalances getting caught in the crossfire (e.g. South Africa, Malaysia). At this stage, however, we attach little probability of this occurring.

External Financing Requirement (System Wide - USDbn)

At first glance, the latest available information related to Turkey's external indebtedness appears relatively encouraging. At end of October, the short-term external debt stock increased by a mere USD252m from the end of 2015, reaching USD102.6bn. However, when the external debt amortisation is also included, i.e. considering the short-term external debt stock on a remaining maturity basis (calculated based on the external debt maturing within 1 year or less regardless of the original maturity), the short term external debt stock (debt amortisation in the below table) increased by nearly USD4.5bn to USD164bn, which certainly changes the picture quite considerably.

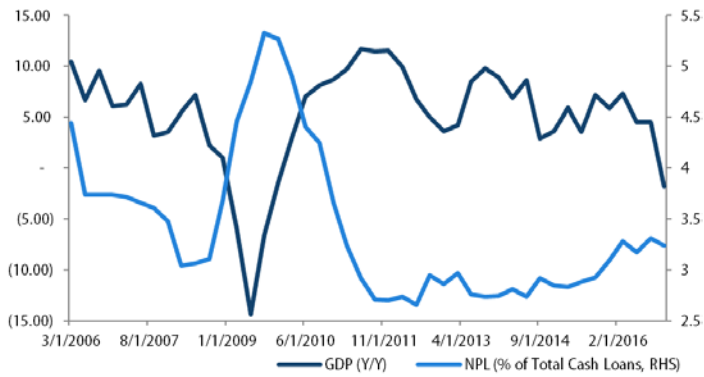
External Financing Position	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Oct-16
Current account *	74.40	47.96	63.61	43.55	32.28	33.70
Debt Amortisation**	130.27	144.19	167.69	166.80	159.89	164.30
Public sector	11.23	8.36	7.51	6.3	4.79	6.2
Central Bank	4.93	3.77	2.64	1.4	0.49	0.8
Government	6.3	4.59	4.87	4.9	4.3	5.4
Private Sector	119.04	135.83	160.18	160.5	155.1	158.1
Banks	60.16	75.3	99.52	107.5	95.6	95.5
Other Sector	58.88	60.53	60.66	53	59.5	62.6
Total External Financing Requirment	204.67	192.15	231.30	210.35	192.17	198.00

*Source: CBRT, * 12 cummulative current account deficit; **external debt stock on a remaining maturity basis*

At this point, given the continued accommodative global liquidity conditions, the risk to rolling over external debt in 2017 appears relatively low; yet the cost of external borrowing is most certainly set to rise, potentially putting strain on the health of Turkey's financial system, particularly its banks.

Banking Sector

Non-Performing Loans



Source: Bloomberg

The key factor contributing to the challenging operating environment for banks is the system-wide reliance on wholesale markets. The Turkish banking system's average net loan to deposit ratio of 120%, so the gap is filled by short-term wholesale funds, predominantly from abroad. It is understood that as much as 50% of these liabilities will mature within the next 12 months. This in itself is perhaps not a major concern, for as long as banks are allowed to offer attractive interest rates to compensate international investors for risk taking. Banks are also fully currency hedged, and have ample protection against deterioration in asset quality, with capital adequacy in the region of 16%, well above the minimum set by the Basel Accord. Yet, Turkish banks are a part of a complex global financial network and their access to foreign capital is certainly affected by the rest of the world's perception of Turkey.

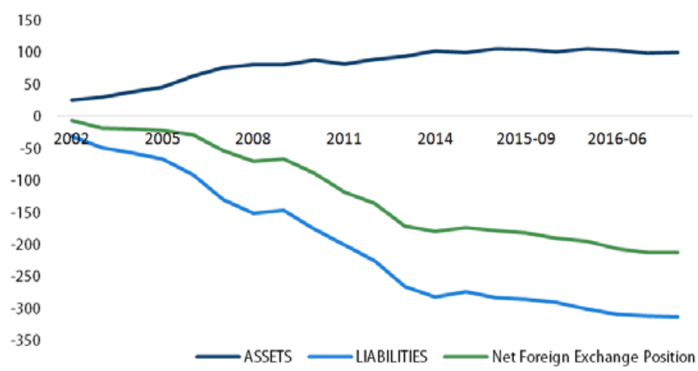
The banks are now faced with home-grown pressures, particularly from the government. Erdogan's efforts to keep interest rates artificially low, in order to boost credit growth, will likely exert further strain on the already weak earnings margins, impacting banks' operating environment. Furthermore, even though banks in general are not running a short FX position themselves, their clients certainly often are, which exposes them to the second round effects of undue FX volatility. The short FX exposure that the corporate sector accumulated to date has not led to any significant asset quality problems for the banks; yet there is no guarantee that quality will continue to be unaffected, if the weakening of the Lira remains unabated. As such, the most critical issue for Turkish banks is how much bad debt will increase given growing pressures on the Lira.

The IMF warned earlier this year that the currency's decline, in the magnitude of some 20%, could result in pushing corporate leverage beyond 200%, from 165% then, exposing banks and potentially driving the economy into a recession. The Lira has collapsed over 30% since then, so it is not surprising that the economy had its first quarterly decline since 2009 (although partially exacerbated by methodological change). The current domestic and external environment is unlikely to see the economy pick up in any meaningful way, unless the government decides to go on a fiscal spending rampage.

The experience of the global financial crisis and the ensuing recession proved that non-performing loans (NPLs) tend to build up very rapidly. We don't expect that Turkey's economy will be driven into a prolonged recession, but banks asset quality is bound to deteriorate merely on the back of the evident economic slowdown. In addition, back then corporate leverage and FX vulnerability was much smaller than it is currently, thus the impact of NPLs could be much greater than it was in 2009. According to official data, current NPLs are running in the range of 3.0-3.5%, but this picture is somewhat masked by rolling over problematic loans. Unofficial analysis suggests that actual NPLs could be as high as 6.0-6.5%, thus some restructuring of these problematic loans could be a topic of discussion in not so distant future.

Net foreign exchange position of the non-financial sector

Net Foreign Exchange Position USDbn



Source: CBRT

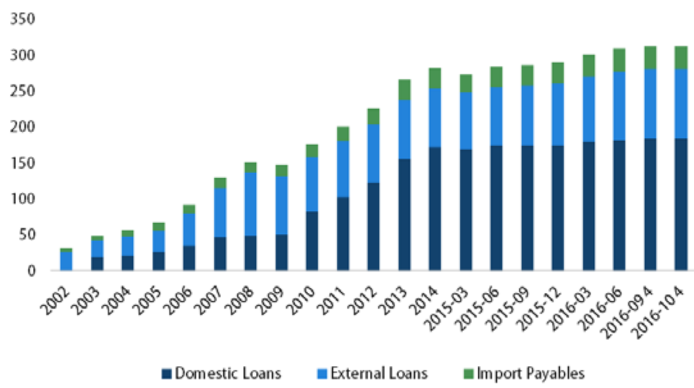
A deeper dive into official statistics showed that FX asset formation outpaced liabilities, indicating a decline of USD363m in the FX deficit, compared to September. Even though this is certainly a positive development, the total net FX open position (USD213bn) continues to pose a grave risk to financial stability. As evidenced by the chart above, the pace of deterioration in external imbalances, particularly after the end of the global financial crisis, was rather astonishing. This is largely explained by the emergence of cheap and abundant liquidity from abroad supplied by most major developed market central banks, which found its way to Turkey, as a search for yield ensued.

Composition of Assets USDbn

Source: CBRT

Despite the somewhat improved competitiveness versus trading partners, on the back of a much weaker currency, export receivables remained subdued, while FX bank deposits appear to have also weakened of late (see the composition of Assets chart above), resulting in the virtually unchanged asset position since 2014.

Composition of Liabilities USDbn



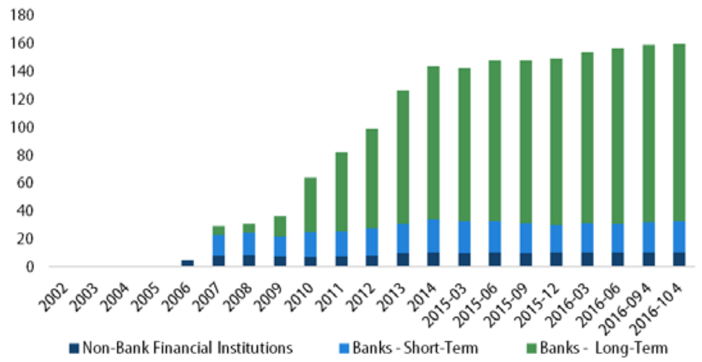
Source: CBRT

Alarmingly, however, non-financial companies' liabilities continued to worsen with both domestic and external FX loans accounting for the largest part of this deterioration.

FX Liabilities - External Loans USDbn

Source: CBRT

FX Liabilities - Domestic Loans USDbn



Source: CBRT

Despite this clear deterioration in the net FX position, FX liabilities appear to have been concentrated in the longer – term (this is true for both domestic and external loans), somewhat alleviating pressure to refinance during the most turbulent of times; yet a prolong episode of Lira sell off, which we are currently observing could start to pose a roll over risk sooner rather than later.

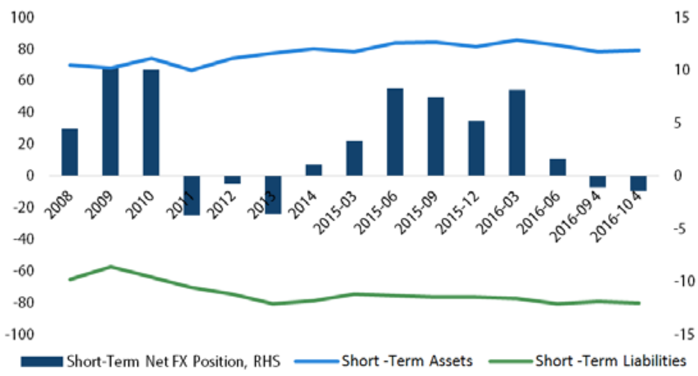
Short Term Liabilities

Source: CBRT

It is often argued that the declining share of short term liabilities as a fraction of total liabilities should be seen as a welcome development. That may well be the case in the situation where total liabilities are shrinking too, as this would suggest improving financial health of the economy. In Turkey's case, we are merely kicking the can down the road, as short term liabilities continue to grow, but at a smaller pace than the total liabilities, suggesting that corporations are simply refinancing for the longer term.

This phenomenon was clearly just opportunistic behaviour on the part of rational agents to roll forward upcoming liabilities and/or taking on new liabilities for the longer term, locking in better terms of repayment, during a period of low and declining rates. With rates now headed potentially even higher, with less global FX liquidity, one can reasonably assume that the previous trend will either plateau, or even reverse entirely.

Short Term Net FX Position



Source: CBRT

In the past, non- financial corporations had some buffers in place to deal with short bouts of excessive Lira volatility by maintaining a long FX position in the short term. The most recent data however, suggests that these reserves have now been depleted.

The large short-FX exposure of domestic non-financial corporates could have severe implications for their capacity to service loans to domestic banks. During past periods of high Lira volatility in both 2014 and 2015, Turkish banks' asset quality showed relative resiliance. This was mainly thanks to the long-term nature of foreign currency lending, some natural hedging (the hard currency exposure mitigated by revenue stream in that currency) of corporates and a degree of restructuring. The key concern here is what happens if Lira volatility persists in the long term. The headline figure of USD213bn of reported FX open position continues to be on the minds of investors. The resilience of Turkish companies to date does suggest that the official data does not capture at least part of both the natural and financial hedges. Given the unavailability of data set (the CBRT only recently started to work on this missing piece of the puzzle), it is impossible to identify the magnitude and the sectoral distribution of the hedges, but construction and energy sectors seem to have been the most exposed to prolonged Lira volatility and at some point servicing their FX loans could become prohibitively costly.

Policy Path

The deteriorating environment has led both the CBRT and the government to take some measured steps in order to relieve funding pressures and calm the financial markets. In the middle of December, to safe-guard financial stability, the Government introduced a provision of state guarantee of up to TRY250bn (USD66bn – although this number seems to be shrinking day by day with a declining Lira) for corporate loans (especially to exporters and SMEs). It is understood that the government has set aside some 10% of that amount as provision for these liabilities to restructure the most problematic loans. The full fiscal cost of this scheme will only be known in around five years, when these loans mature. This looks to be another measure that merely masks the problem, than rather tackling it at its core.

As for the CBRT, the next scheduled meeting is set for January 24. To date, Governor Murat Cetinkaya, has remained indifferent (or rather reluctant to act decisively due to political pressures) to arrest Lira depreciation, instead managing daily liquidity by restricting access to Lira funding. To ease access to USD funding, the CBRT encouraged banks to reduce their FX deposits at the central bank by cutting the FX reserve requirement rate and making technical adjustment to reserve option coefficients. This effectively boosted FX liquidity, but at the expense of declining FX reserves. At the end of last year, the CBRT's gross reserves decreased USD14bn to USD92bn. Clearly the situation cannot go on for much longer due to a very limited stock of FX reserves. As such, we anticipate the CBRT to take decisive action at its next MPC meeting, and regain at least a small portion of its credibility, which judging by the price behaviour of the Lira, must be running particularly low these past few months.

Fiscal Policy

The recent slowdown in economic activity will be alleviated somewhat by fiscal relaxation. Fortunately, Turkey's relatively strong fiscal position will afford the Ministry of Finance some scope to introduce countercyclical policy measures, without necessarily endangering its fiscal position. We expect Turkey's fiscal deficit to remain around 3% of GDP, which is still relatively enviable when compared to other large emerging markets and even some developed countries. Fiscal prudence evidenced by a low public debt/GDP ratio (ca. 35%) has been a bright spot for Turkey's policymaking for a number of years and authorities are unlikely to put that into jeopardy, knowing well the importance of such as an anchor of confidence for international investors.

Politics

The coup attempt last year was interpreted by Erdogan as a clear signpost of the failure of the current political setting. As such, a final push for a fully-fledged presidential system is currently being pursued. Given the temporary state of emergency, introduced shortly in the aftermath of the coup, Erdogan has de facto become a president with full executive powers. In order to legitimise his current position, he has called a referendum to be held in April, as the ruling AK party lacks the required two-thirds majority to make constitutional changes in parliament. To be successful in the plebiscite, he needs the ongoing support of nationalist voters (supporters of the opposition Nationalist Movement Party, MHP) and his own AK party, alike. To maintain his popularity among the MHP, he will continue his hard-line stance on the Kurdistan Workers Party (PKK), ruling out a return to viable peace talks, and its affiliates in Iraq and Syria. In both those countries, Erdogan is likely to overreach and alienate allies. And his hard line will continue to stoke terrorism in Turkey. Similarly, while the EU-Turkey refugee deal is more likely than not to hold, Erdogan's repressive policies will keep his relationship with European partners on a knife-edge.

Conclusion

The wrath of Erdogan towards the Gulenist movement, and the ensued purge of the parallel state, has resulted in an erosion of institutional checks and balances, and equally important standards of governance. The impact on economic activity was pronounced. GDP contracted for the first time since 2009, as private investments and consumer confidence faltered. The latter was further weakened by the numerous and extremely bloody terrorist attacks undertaken by ISIS militants on Turkish soil, as retaliation for the country's involvement in Syria. At the same time, higher oil prices coupled with domestically-led price pressures have yet again seen inflation forging ahead.

The CBRT has so far remained reluctant to deliver an orthodox policy response, due to political pressures from Erdogan ahead of planned constitutional changes to legitimise his de facto executive presidency. The extent of Lira weakness in the past few months has left many investors stunned, frantically searching for answers in the largely uneventful and unhelpful MPC meetings and the CBRT communique, leading yet again to a further erosion of the CBRT's credibility.

More importantly, the recent Lira slump poses a grave risk to financial stability, given the significant net short FX position of the non-financial sector. The latter point is particularly significant for the overall health of the banking sector, which otherwise is in a relatively good shape. The indirect credit risk, which stems from a high amount of commercial loans in foreign currency, could result in a significant deterioration in asset quality of the banking sector. For the time being, healthy capital buffers available to banks mitigate the risk to a full blown financial crises domestically, but further Lira weakness is likely to be a first step in that direction. The banking sector is fully hedged; the issue here is that the banks' clients are not.

From the macroeconomic perspective, the country has been burdened with excessively high CADs, due to very low savings rates. The latter can be partially explained by the fact that Turkey has a very young population, whose propensity to save is very low. Indeed, nearly 65% of Turks are of age 30 or less. Secondly, and relatedly, the asset management industry remains underdeveloped with pension funds only at around 2.5% of the GDP (compared with 66% in Chile). The Government is well aware of the situation and has recently introduced a number of measures that aim at reducing the reliance on foreign financing of the CAD, such as auto-enrolment into the pension system. The government forecasts that as much as 2% of the future CAD could be financed via this channel, bringing down the structural deficit to a more manageable level of 2-3%. These measures are, however, medium term considerations; in the short term the only solution is to offer attractive rates to lure foreign capital. The CBRT is currently conducting a "back door" monetary policy tightening, by restricting lira liquidity via regular channels, and allowing access only to the late liquidity window, which demands premium of 200bps over the benchmark repurchase rate of 8%. If investors continue to be unimpressed by such, then more decisive intervention will be required.

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