TURKEY: LOOMING CHALLENGES

Market commentary | July 2019

Lira depreciation will continue over the longer term

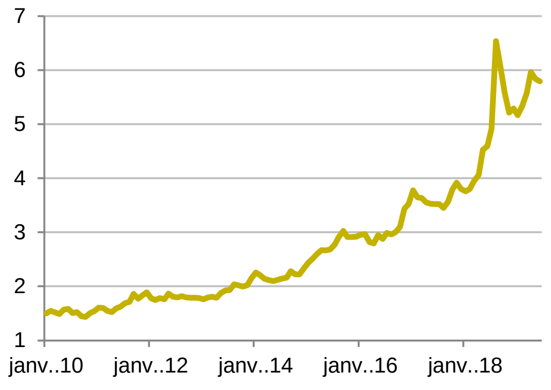
Lira exchange rates have stabilised in recent weeks, reflecting the decline in year-on-year Turkish inflation rates and indications of looser US Federal Reserve monetary policy in the near future. We believe the respite for the lira will not last for long. The decline in Turkish inflation is largely due to base effects. Month-on-month CPI inflation has remained high for most of this year, pointing to an annual inflation rate of around 15%. Consequently, if month-on-month inflation does not decline, we expect Turkish year-on-year inflation rates to rise later this year, once the base effects fade.

The removal of Turkish Central Bank (CBRT) governor Murat Cetinkaya also complicates the outlook for the lira. His removal from office will lead to questions about the CBRT's independence, but in reality few analysts believe that CBRT enjoys even a small degree of independence from the Turkish government. Cetinkaya's removal will result in CBRT rate cuts over the coming months, which will lead to a decline in Turkish real interest rates. This pro-cyclical policy mix may result in improved growth metrics but this will come at a cost; higher inflation and a widening in the Turkish current account deficit. Fundamentally speaking, the combination of high inflation, high inflation expectations, a constantly weakening currency and a widening current account deficit can only be realigned with high real interest rates.

As a result of this paradigm, we expect the lira to depreciate later in the year. The question is by how much? In a benign scenario, USD/TRY can move to levels of around 6.20 / 6.50. However, the depreciation could be much greater, with USD/TRY easily moving to levels above 7.00. The problem for the lira is that such moves tend to be aggressive and brutal, despite the punitive cost of carry; current CBRL rates are 24%, although they are likely to decline over the coming months.

Chart 1: **Longer-term TRY depreciation**

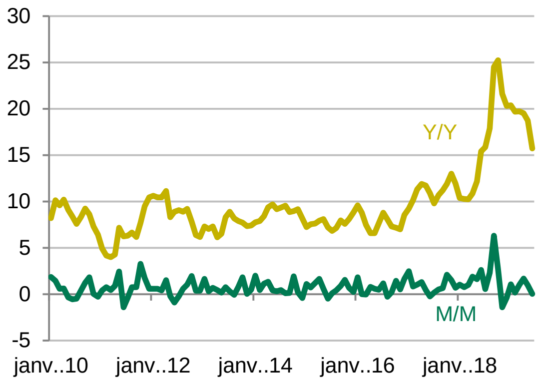
USD/TRY spot



Sources: UBP, Bloomberg Finance L.P.

Chart 2: **High inflation**

Turkey CPI, Y/Y, M/M, %



Sources: UBP, Bloomberg Finance L.P.

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Weaker lira set to put pressure on bank capital

We are particularly concerned about the negative impact of TRY depreciation on Turkish banks' capital ratios. Our base case includes a USD/TRY exchange rate of around 6.5 in 2H19 on average. Assuming sudden TRY depreciation combined with NPLs increasing to around 10% (based on 50% of stage 2 loans turning into NPLs), that would mean top tier Turkish banks requiring fresh capital injections totalling around US$4bn. However, assuming a more severe TRY depreciation to 7.5 against the US$ this year, combined with the NPL ratio increasing to around 10%, this would imply a capital shortfall of US$6bn for top tier banks.

However, the government typically has a number of levers to pull before the situation deteriorates significantly:

1) Last year, the government allowed the banks to use the old exchange rates for capital calculations, which may happen again this year.

2) The new Central bank governor is also in discussions about introducing potential measures to encourage privately owned banks to resume lending, which in turn could mask NPL ratios. One such measure could be to impose penalties in the form of higher reserve requirements on banks that have low lending rates. As we have seen in the latest financials, loan growth declined significantly in 2Q19: the state-owned bank loan book grew by only 2% in 2Q19, whereas that of privately owned banks contracted by 2%. Hence, overall loan growth across the banking sector was 0% in 2Q19.

3) Additionally, the government may choose to provide support measures as it has in the past, and in April 2019 the government provided a EUR3.4 bn support package to state-owned banks.

Table 1: **Base case: USDTRY 6.5**

1Q19 Consolidated financials (millions)

	AKBNK	GARAN	YKBNK	ISCTR	HALKB	VAKBN	Total
Asset quality and currency shock (no PPP included)							
Adjusted T1 capital	46,397	47,490	38,749	52,202	34,678	38,517	
Total provision requirement	21,458	30,235	27,957	29,353	20,650	23,316	
Incremental provisioning need	11,079	12,678	12,420	13,905	10,440	9,558	
% of gross loans	*4.9%*	*4.5%*	*4.8%*	*4.4%*	*3.6%*	*3.6%*	
Hit on capital	8,641	9,889	9,688	10,846	8,143	7,455	
T1 capital post asset quality shock	37,756	37,601	29,062	41,356	26,534	31,062	
T1 ratio post asset quality shock	11.3%	10.5%	9.1%	9.4%	8.8%	11.0%	
T1 ratio post asset quality AND currency shock	10.4%	9.8%	8.5%	8.7%	8.4%	10.4%	
Excess/(shortfall)	-0.6%	-1.4%	-2.1%	-1.8%	-1.7%	0.4%	
(Shortfall) - TRY	-2,116	*-5,282*	-7,135	-8,536	-5,304	0	**-28,373**
(Shortfall) - USD	-326	-813	-1,098	-1,313	-816	0	**-4,365**

Sources: UBP, Banks' financial statements

Table 2: **Stress case: USDTRY 7.5**

1Q19 Consolidated financials (millions)

	AKBNK	GARAN	YKBNK	ISCTR	HALKB	VAKBN	Total
Asset quality and currency shock (no PPP included)							
Adjusted T1 capital	46,397	47,490	38,749	52,202	34,678	38,517	
Total provision requirement	21,458	30,235	27,957	29,353	20,650	23,316	
Incremental provisioning need	11,079	12,678	12,420	13,905	10,440	9,558	
% of gross loans	*4.9%*	*4.5%*	*4.8%*	*4.4%*	*3.6%*	*3.6%*	
Hit on capital	8,641	9,889	9,688	10,846	8,143	7,455	
T1 capital post asset quality shock	37,756	37,601	29,062	41,356	26,534	31,062	
T1 ratio post asset quality shock	11.3%	10.5%	9.1%	9.4%	8.8%	11.0%	
T1 ratio post asset quality AND currency shock	9.6%	9.0%	7.9%	8.1%	8.0%	9.8%	
Excess/(shortfall)	-1.4%	-2.1%	-2.7%	-2.4%	-2.1%	-0.3%	
(Shortfall) – TRY	-5,454	*-8,756*	-9,946	-12,475	-7,051	-816	**-44,498**
(Shortfall) – USD	-727	-1,167	-1,326	-1,663	-940	-109	**-5,933**

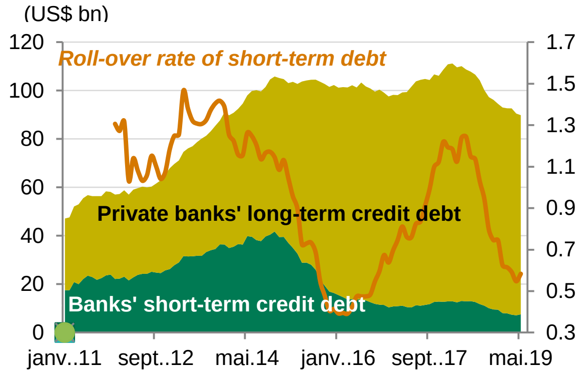
Sources: UBP, banks' financial statements

Blue chip exporters could be a safer option

We remain concerned about Turkish banks and consider blue chip Turkish corporates to be a safer option, primarily those that have a large portion of their revenues denominated in hard currency. Blue chips successfully took advantage of the market window in 1Q19 and refinanced short- to medium-term debt, effectively creating liquidity buffers for this year. Exporters have a natural hedge given the high proportion of their revenues generated in hard currency, which makes them more immune to local currency depreciation. For example, Koç Holding generates 50% of its revenues in hard currency, and no more than 50% of its costs are in hard currency. It also holds cash, which is primarily denominated in hard currency.

Regarding the broader situation for Turkish corporates across the credit quality spectrum, roll-over rates are our main concern. Recent data indicates that roll-over rates declined to 58% in May 2019 for privately owned banks and stood at around 70% for corporates, including banks. Whist a temporarily low roll-over rate may be manageable for privately owned banks given their high hard currency liquidity buffers, it is not the case for Turkish corporates more broadly. Further deterioration in roll-over rates could become a problem. Short-term external corporate debt attributable to Turkish corporates were as high as US$72 bn, in addition to US$67 bn related to financial institutions. The majority of this short-term debt was in hard currency.

Chart 3: **Private banks' roll-over ratio (%)**
Based on monthly data



Sources: UBP, CBRT

Chart 4: **Short-term external debt ($m)**
As of April-2019

PUBLIC SECTOR	31,045
GENERAL GOVERNMENT (**)	3,027
FINANCIAL INSTITUTIONS	27,958
Banks	27,958
Non-Banking Institutions	0
NON-FINANCIAL INSTITUTIONS	60
CBRT	5,424
PRIVATE SECTOR	138,827
FINANCIAL INSTITUTIONS	66,697
NON-FINANCIAL INSTITUTIONS	72,130
TOTAL	**175,296**

Sources: UBP, CBRT

How should investors be positioned ahead of potential rate cuts this week?

Assuming the CBRT cuts rates in line with consensus expectations, by around 225 bp (bringing the base rate to 21.75%), we anticipate that TRY may rally modestly. However, this will depend on the CBRT's comments, and specifically whether future rate cuts are front loaded or back loaded. If it is the former, then the TRY rally will not last long. We believe investors should not jump into aggressive TRY long positions because of the risk of higher CPI inflation later this year. Consequently, we would pursue a strategy of buying on the dips at levels of around 5.45.

With respect to credit, we expect Turkish banks to experience further weakness in relation to asset quality as well as pressure on capital. CET1 capital is primarily denominated in local currency, whereas risk-weighted assets are predominantly in hard currency, thereby making Turkish banks vulnerable to sizeable currency swings. We believe that blue chip corporates with large revenues in denominated in hard currency are in a better shape to weather the storm.

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