24 January 2017

Flash Comment

Turkey's central bank: to hike or not to hike?

- **We expect Turkey's central bank (TCMB) to hold the benchmark repo rate unchanged on 24 January as political pressure to keep the economy growing prevails. A 50-100bp 'cosmetic' hike is still likely.**
- **We expect the TRY's fast devaluation to be halted via different legislative and monetary tools, although rating agency Fitch's possible downgrade of the country rating could restart the sell-off.**
- **The TRY has been hit by a perfect storm of negative domestic developments and foreign factors, including a stronger USD, higher oil prices (affecting the current account negatively) and higher US yields.**
- **We see USD/TRY at 3.95 in 1M, falling further to 4.15 in 3M, 4.25 in 6M, while increasing to 4.50 in 12M.**

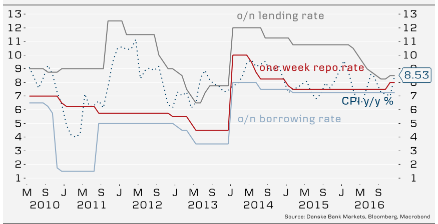
Assessment and outlook

On Tuesday (24 January 2017) at 12:00 CET, the TCMB is due to announce its monetary policy decision. We expect the TCMB to keep the benchmark repo rate unchanged at 8.00%, while consensus expects a 50bp hike. 2016 has been the worst year for the TRY since the Fed started talking about tapering in the spring of 2013, and during the first three weeks of 2017 the TRY has been the worst performer in the EM universe. The lira's continuing weakening poses additional risks for the country's banking and corporate sector, reducing private consumers' purchasing power through accelerating inflation.

Turkey's deteriorating macro fundamentals, geopolitical issues (possible confrontation with the EU) and internal problems (the failed coup attempt and subsequent high numbers of arrests) combined with expectations of a hawkish Fed and a strengthening USD have been the major factors weighing on the TRY during the past 12 months, and there is no noticeable relief to be seen in any of those components. While we believe that the political pressure to restrain the TCMB from hiking has been high enough, a 50-100bp 'cosmetic' hike of the benchmark rate would not at present be a game changer for the TRY. The key event for the TRY's future prospects will be Fitch's country rating revision on 27 January. At the moment Fitch is the only major rating agency that is keeping Turkey at investment grade. The market is already pricing in a downgrade. Thus, if the country keeps its investment grade, it would be significantly TRY positive.

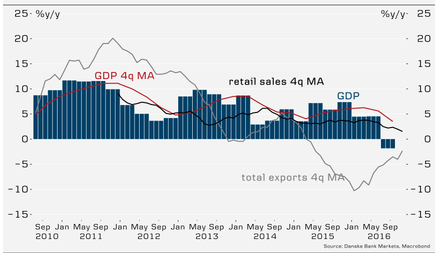
We still expect a moderate tightening of TCMB's monetary policy in 2017, leaving space for a gradual shift up in the interest rate corridor and pushing its upper bound (the overnight lending rate) from the current 8.50% to 10.0% in 2017. At the same time, other legislative or monetary tools can be used to cushion the TRY's excessive fall and ease the pain of the corporate sector. For example, Turkey's government has already published a decree according to which Turkey's state organisations and companies in which the state owns a stake can use the FX exchange rate from 2 January 2017 (USD/TRY circa at 3.54) to claim FX debt from private debtors in the TRY. The rate is applicable to receivables due by 31 December 2017.

Off-target inflation has been the new normal for a while



Source: Bloomberg, Danske Bank Markets

Turkey's GDP is set to slow down further



Source: Macrobond Financial

Falling but still high FX leverage

Source: Danske Bank Markets

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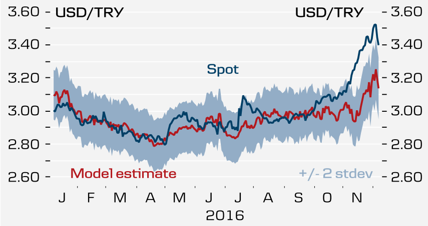
We still exclude aggressive hikes by the TCMB in 2017 as political pressure would be likely to prevent it. However, it has other tools to restrain a further decline in the TRY, e.g. substantial FX sales (through different channels), cutting further FX reserve requirements for local banks and limiting TRY liquidity.

The USD/TRY is still looking over-bought. According to our short-term financial model, the fair value of USD/TRY is 3.5240. However, given the negative factors listed above, there is more upside than downside pressure to the current USD/TRY levels, as our model does not include political factors that could start weighing on macro fundamentals soon. We see USD/TRY at 3.95 in 1M, falling further to 4.15 in 3M, 4.25 in 6M, while increasing to 4.50 in 12M.

USD/TRY is still overbought while politics and the Fed's possible hikes weigh on the TRY



Source: Bloomberg, Danske Bank Markets

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This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S (‘Danske Bank’). The author of the research report is Vladimir Miklashevsky, Senior Analyst.

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None.

Date of first publication

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