Monitoring Turkey: Central bank setting the stage

GDP data has confirmed a moderation in activity, indicating that Turkey has been in a technical recession since the third quarter of the year. Although the Central Bank of Turkey (CBT) has signalled the start of gradual rate cuts, the activity data bolsters the case for a cut in December

Turkey's economy: at a glance

- Year-on-year GDP growth lost momentum in the third quarter and the growth composition showed the impact of tighter monetary and financial conditions on domestic demand.
- We expect economic activity to remain soft in the last quarter, though some of the recent indicators ie capacity utilisation, real sector confidence, and retail and construction sector indices showed a recovery in November. We see a tight monetary stance prevailing in the period ahead and forecast GDP growth this year at 2.8%.
- The food group was again the reason for the higher-than-expected November reading after a strong contribution in October, though the downtrend in annual inflation has remained in place. While the tightening in financial conditions and monetary policy has started to contribute to the return to the disinflation path, this will likely continue in the period ahead.
- CBT communication suggests we are nearing a gradual rate-cutting cycle, implying a December move as a real possibility. The revised guidance also tied rate cuts to both

realised and expected inflation implying that the bank will closely watch ex-ante and ex-post real rates. Accordingly, we expect a 250bp cut from the bank this month, though do not rule out a smaller move given the higher-than-expected figure and no meaningful improvement in the underlying trend in November, implying continuing challenges to disinflation efforts.

- The CBT expects a significant contribution from the increased coordination of fiscal policy to the disinflation process. The 12M rolling deficit as of October is close to the end-year target (4.9% of GDP) specified in the Medium-Term Plan.
- The CBT adjusted the reserve requirement ratios by cutting the ratio for TRY-denominated required reserves that should be maintained for FX deposits to 4% from 5% and hiking reserve requirement ratios for short-term TRY deposits to 17% from 15%. The cumulative impact of these moves should not be significant given the relatively small size of liquidity withdrawn in comparison to the size of excess liquidity in the system.
- The CBT also abolished the TRY deposit share target for legal persons and reduced the total target for KKM accounts' transition to TRY and renewals from 75% to 70%. These moves should be related to the ongoing healthy pace of decline in the KKM stock and continuing de-dollarisation, allowing the CBT to simplify the macro-prudential framework.

Quarterly forecasts

	3Q24	4Q24F	1Q25F	2Q25F	3Q25F	4Q25F	1Q26F	2Q26F
Real GDP (%YoY)	2.1	1.6	0.1	2.1	3.7	3.9	4.4	4.3
CPI (eop, %YoY)	49.4	44.8	34.7	30.8	26.0	24.7	22.8	20.4
Central bank key rate (eop, %)	50.00	47.50	40.00	34.00	31.00	28.00	25.00	22.00
3m interest rate (eop, %)	48.88	45.20	40.72	34.72	31.18	28.78	25.06	23.46
10yr yield (eop, %)	28.40	27.50	24.76	21.67	20.72	20.08	16.91	16.11
USD/TRY exchange rate (eop)	34.16	35.00	37.17	39.03	40.63	42.00	43.50	45.00
EUR/TRY exchange rate (eop)	38.00	36.75	38.66	40.60	42.26	42.84	43.94	45.90

Source: Various sources, ING

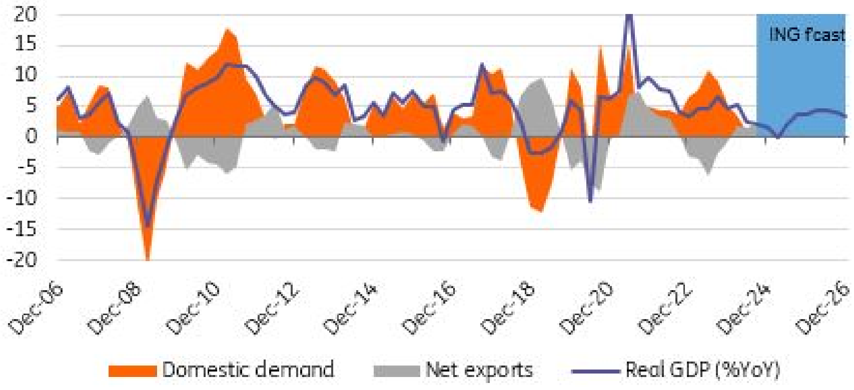
GDP growth continues to slow in the third quarter

GDP growth in the third quarter came in at 2.1% on a year-on-year basis, below the market consensus (2.6%) and our call (2.4%) and driven by gross fixed capital formation.

The Turkish Statistical Institute, TurkStat, also revised second-quarter GDP expansion down to 2.4% from 2.5%. Accordingly, nine-month GDP growth stood at 3.2%. On a seasonally adjusted basis, following TurkStat's downward revision for the second quarter, the sequential growth in this period turned to negative -0.2% quarter-on-quarter. Third-quarter GDP, on the other hand, recorded a negative QoQ growth rate of -0.2%.

This shows further weakness as Turkey is now in a technical recession. Its feeble sequential performance is attributable to government consumption turning negative as well as further weakness in private spending and a negative contribution from inventories.

Real GDP (%YoY) and contributions (ppt)



Source: TurkStat, ING

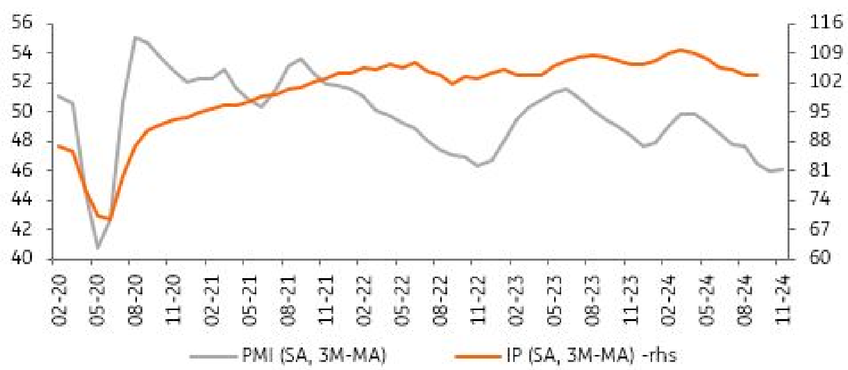
The PMI is rising but is still in contraction territory

After plunging to the lowest level since early 2019 (if we exclude extraordinary conditions during the Covid-19 pandemic in 2020) at 44.3, the manufacturing sector PMI has adopted a recovery trend in the last two months and reached 48.3 in November.

The improvement is attributable to output and new orders moderating to much lesser extents than in October, while employment ended a nine-month moderation with a renewed rise.

Inflationary pressures continue to diminish as input cost inflation has eased for the fourth consecutive month, reaching a two-year low, and output prices have seen the slowest increase in five years. All In all, the increase in the headline PMI suggests there are tentative signs of demand improvement in the last quarter of 2024, it has remained in contractionary territory since April implying ongoing challenges for manufacturers.

IP vs PMI



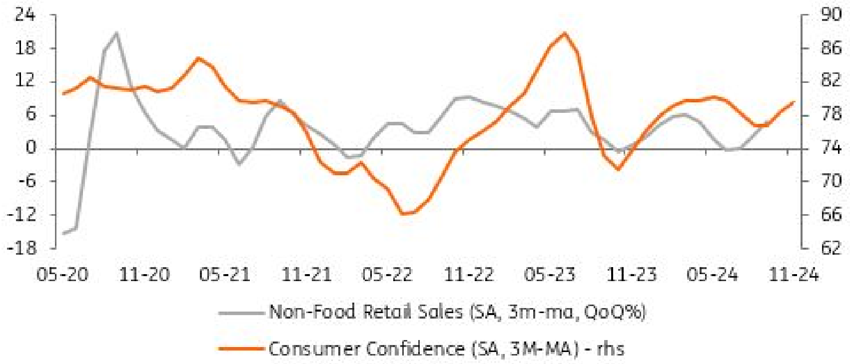
Source: ICI, TurkStat, ING

Retail sales on the rise

Sequential growth in retail sales that turned positive in June remained so in the following months and recorded a 2.3% MoM increase in September thanks to widespread strength in all sub-items except fuel. The underlying trend of industrial production (IP) on the other hand has remained weak, leading to a widening gap between retail sales and IP. According to the CBT, the increase is milder when gold is excluded.

Retail sales volume on a calendar-adjusted basis, however, returned to double-digit territory in August after single-digit growth rates in the previous three months continued with a higher pace in September, recording 15.9% YoY growth. While the CBT expects domestic demand to continue to slow, reaching disinflationary levels, recent signs of improvement in this area are drawing attention.

Retail sales vs consumer confidence



Source: TurkStat, ING

Food prices drive a higher-than-expected rise in inflation

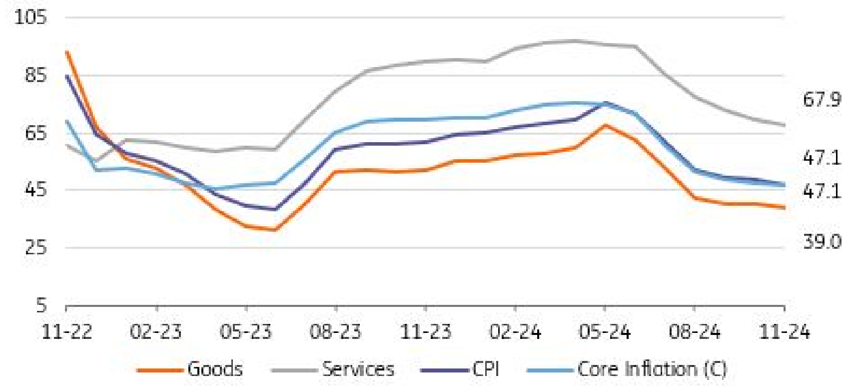
November inflation turned out at 2.2%, higher than the market consensus at 1.9% (and our call at 1.8%). However, the annual figure has maintained its declining trend and fell to 47.1% from 48.6% a month ago, given favourable base effects (as it was 3.3% in November 2023).

Cumulative inflation reached 47.1% vs the CBT's revised 44% forecast for the whole year. In the breakdown, the food group was the major contributor to the headline again with 1.23ppt. Compared to the same month of last year, unprocessed food inflation recorded a strong increase (9% vs 0.3% last year) with the highest November figure in the current inflation series and determined the upward move in food inflation.

Processed food prices, on the other hand, showed a deceleration (1.6% vs 4.9% last year). Accordingly, monthly food inflation at 5.1% was the key factor that contributed to a higher-than-expected increase in November.

Core inflation (CPI-C) came in at 1.5% MoM, the lowest monthly reading since late 2021, moving down to 47.1% on an annual basis, supported by the relatively slow-moving FX basket and increasingly benign PPI outlook. Going forward, pricing behaviour and inertia in services have remained key risk factors, for the pace of the current disinflation process.

Inflation outlook (YoY%)



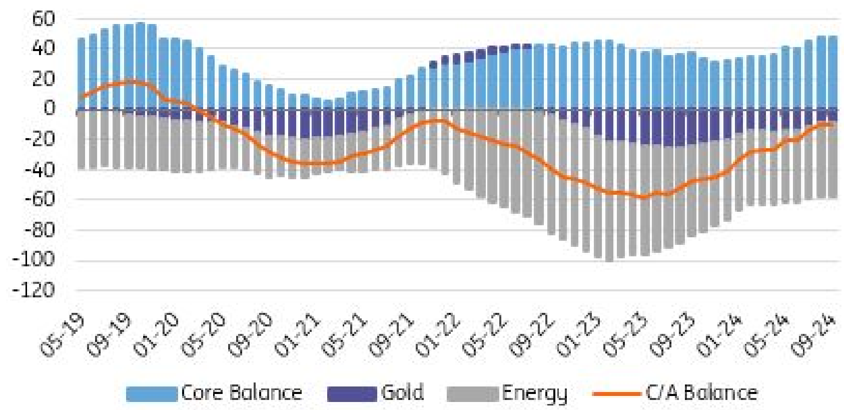
Source: TurkStat, ING

Current account remained benign in September

The September current account balance posted a US$3.0bn surplus, broadly in line with expectations, while it was slightly better than the level realised in the same month of 2023. Accordingly, the 12M rolling deficit that has maintained a narrowing trend to US$9.7bn (translating into c. 0.7% of GDP), from US$9.8bn a month ago was the lowest reading since end-2021.

It should also be noted that the CBT revised the cumulative current account deficit downwards in the first eight months of the year by US$1.4bn. On the other hand, after outflows in August for the first time since January, the capital account turned positive at US$2.5bn, while unidentified outflows remained strong at US$6.2bn. Despite the strong monthly current account surplus and positive capital account, official reserves posted a US$0.7bn drop in September with a large negative reading in net errors and omissions.

Current account (12M rolling, US$bn)



Source: CBT, ING

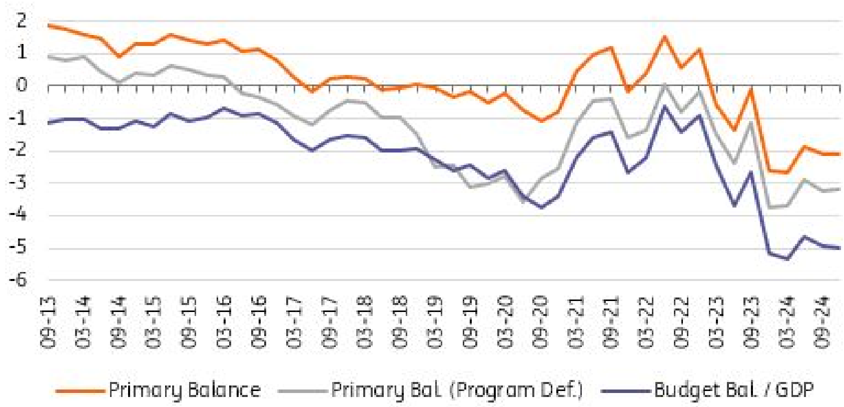
Slight deterioration in October budget deficit

The October budget witnessed a slight deterioration due to the continuing pace in primary spending (up by 9.7% in real terms in October vs 9.6% on a YTD basis), while personnel expenditures, current transfers and capital expenditures determine the growth.

Interest expenditures drew attention with a 37% real increase in October and a 21% real expansion year-to-date. However, revenue collection remained robust (8.9% real vs 7.8% real), despite some weakness in corporate tax collection. Non-tax revenues, on the other hand, accelerated.

Accordingly, the ratio of budget deficit to GDP on a 12M rolling basis stood at 4.8% (primary balance at 2.0% deficit). Excluding one-offs, the primary balance was at a 3.1% deficit (and the total deficit at -5.9%). According to the Medium-Term Plan, the Government aims to narrow the central government budget deficit from around 4.9% this year to 3.1% in 2025, while the Ministry of Finance's Mehmet Simsek recently signalled additional fiscal measures to support the CBT in its disinflation efforts.

Budget performance (% of GDP)



Source: Ministry of Treasury and Finance, ING

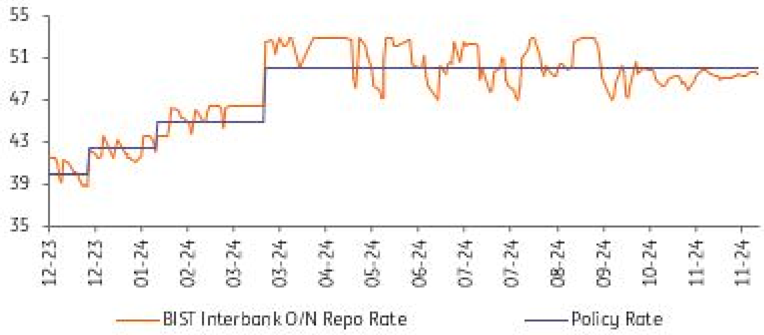
CBT signals supporting December cut expectations

In line with the consensus, the CBT kept rates on hold (50%) at the November rate-setting meeting, while the interest rate corridor was also unchanged with the upper and lower at 53% and 47%, respectively.

In the statement accompanying the decision, the CBT provided a more optimistic assessment of inflation. Additionally, it added a new sentence and pledged to determine the policy rate “in a way to ensure the tightness by the projected disinflation path” which now shows a slower-than-expected adjustment in the headline inflation in comparison to the previous inflation report.

Finally, the CBT anticipates that enhanced coordination of fiscal policy will significantly contribute to the disinflation process. Overall, we believe the latest MPC statement includes changes that further support expectations for the initiation of an easing cycle in December.

The Policy Rate vs. Interbank O/N Rate



Source: CBT, Refinitiv, ING

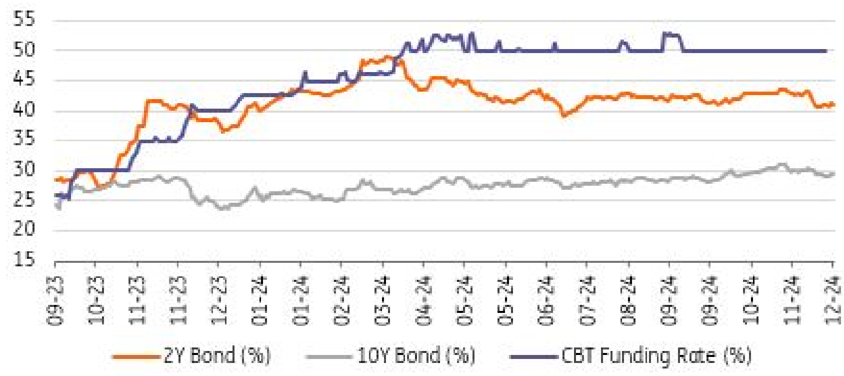
FX and rates outlook

The Turkish lira showed surprising resilience during the US election and was one of the few emerging market currencies to strengthen after the results were announced. However, in November the TRY saw another correction to which the market reacted by unwinding some carry trades. Since then, the pace of depreciation has picked up but is still not outperforming the carry. For the end of the year, we expect to reach 35.00 USD/TRY. However, as we approach the start of the cutting cycle, we can expect the TRY to see higher volatility and potentially close out carry trades. Implied yields continue to slide lower with a steepening bias however still price in fewer cuts than our forecast over the six-month horizon.

Similarly in the rates space, the front of the OIS curve is pricing in more rate cuts, however the recent upside surprise in inflation has triggered some repricing where the market has priced in roughly 100bp of rate cuts over the one-year horizon. Still, for the December meeting, the market sees roughly less than a 200bp rate cut and even here we think the market has room to price in more easing for next year with our forecast of 40% for the base rate at the end of 1Q25.

On the TURKGBs side, we see continued inflows from foreigners with occasional outflows with holders just under 10% in relative terms in November and expect further market normalisation here. Bonds saw some rally in November, especially at the short end of the curve which remains the sweet spot in our view. November inflation has also brought some correction here showing attractive valuations before the cutting cycle begins.

Local bond yields vs CBT funding rate



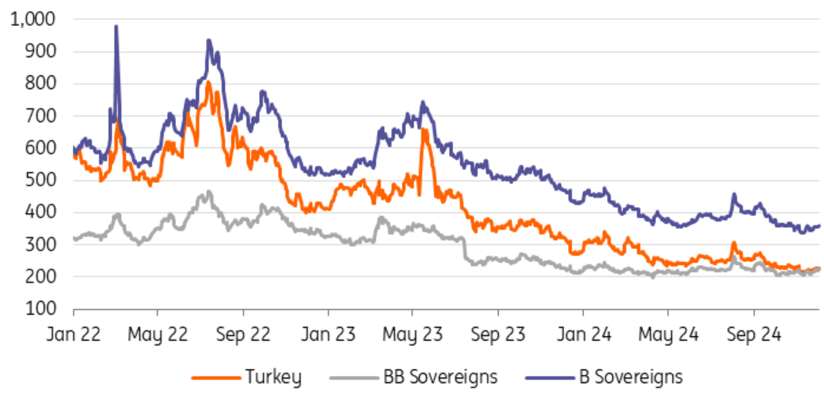
Source: CBT, Refinitiv, ING

Sovereign credit: the squeeze continues

Turkey's sovereign dollar bonds have continued their strong performance for much of the year, with spreads now squeezing towards the BB-sovereign average. We think further sustained progress on the inflation front is needed for spreads to move another leg tighter, along with continued improvements to the external balance sheet. An upgrade to Ba3 by Moody's early next year is a potential catalyst to watch for but is already well anticipated by the market.

With valuations squeezed fairly tight to the rating peer group, we see limited room for a further rally in spreads, while increased external issuance plans for next year could be a slight negative catalyst, in particular in an environment of higher US rates.

ICE US$ Bond Sub-Index Spreads vs USTs



Source: ICE, Refinitiv, ING

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