https://blog.en.erste-am.com/post-election-turkey-whats-next/

Post-election Turkey – What’s next?

Peter Szopo

Peter Szopo – based on contributions from Gerhard Winzer (Chief Economist), Alexandre Dimitrov, Amalia Ripfl and Sevda Sarp (Equity team), and Toni Hauser (Fixed income).

1. **Has the political backdrop improved as result of the election?**

On balance, yes.

President Erdogan’s victory was surprisingly clear, the turnout (87%) surprisingly high. There has been criticism that as a result of the state of emergency in the country, the opposition was at a disadvantage. But even taking this into account, the elections have strengthened Erdogan’s standing and will lend credibility to the soon-to-be-formed government.

In addition, the end of the state of emergency, which has been rumoured as of late will be seen as a step toward political normalization.

2. **What can we expect in terms of economic policy?**

Difficult to say.

President Erdogan leans towards heterodox economic policies with a strong expansive bias, without fully acknowledging macroeconomic, financial or institutional constraints. His campaign rhetoric does not indicate that he intends to implement a major change in his economic policy stance, at least not until the municipal elections in March 2019. Therefore, until then our base case is a muddle-through scenario, characterized by persistent vulnerabilities on the external front and high domestic inflation. Volatility will likely remain elevated, depending – among other things – on EM capital flows and global risk appetite.

3. **What are the near-term prospects/issues of the Turkish economy?**

The most likely scenario is that growth will slow down, inflation will stay high, monetary policy will remain tight and the budget deficit will deteriorate.

Following the extremely rapid growth of 7.4% y/y in the first quarter, GDP growth will likely slow down going forward, settling in the 2-3% range for the rest of the year. In the past four months, the manufacturing PMI has dropped by almost ten percentage points and is now (at 46.8) hovering at a multi-year low. Still, for the full year GDP growth is assumed to be around 4%, which will be sufficient to allow the government sticking to the existing policy setting, i.e. neither adding new nor revoking the existing stimulus introduced prior to the elections.

Inflation remains a key issue. The CPI’s last print was above 15%, well ahead of expectations. This could be the peak, and most forecasts assume a modest decline in the 2nd half of the year, depending on the further TRY trajectory, the oil price environment and any tax measures that could result in higher prices (unlikely in our view).

Monetary policy has been on a tightening course in recent months. Despite some political headwind, the CBT has raised the key policy rate by 500 bps year-to-date to 17.5%. As the economy will be cooling off – thereby auto-correcting some of the imbalances (particularly the external balance) – we assume that the central bank is near the peak in its hiking cycle, but in light of the latest inflation data (above 15%) another upward move (at least) looks increasingly likely.

If and when the CBT will be in a position to again lower rates will be mainly determined by currency developments, i.e. whether the TRY stabilises at its current levels or whether the external backdrop (i.e. dollar movements, risk appetite, US rates) will continue putting pressure on EM currencies in general and fragile currencies such as the TRY in particular.

The budget has deteriorated in the run-up to the election, and the worst is yet to come as a result of election promises. Pensioners were promised a payment of TRY 2,000 per person over the two religious holidays (June and August). In addition, the government has also cut the special consumption tax (SCT) on fuel (which accounts for 13% of total tax revenues) to offset both the rise in the crude price and TRY depreciation. The 12-month trailing central government deficit, presently at 1.6% of GDP, will likely widen to 2-2.5% by year-end. We do not expect the ruling parties to support any austerity measures ahead of the March 2019 municipal elections. Expenditure cuts would be anti-growth, while a reversal of the SCT reduction for fuels would push inflation even higher.

4. **Why is Turkey among the “fragile” emerging markets?**

This is the result of the country's substantial short-term financing needs at a time when the USD dollar is strengthening, crude prices are firming, and global liquidity is falling.

Turkey runs a significant and widening current account deficit. From January to April, the cumulative deficit had increased by 80% in USD-terms on a year-on-year basis and for the full year it is expected to come in at 5.9% of GDP. Together with substantial debt repayments due in the next twelve months of c. USD 180bn (end of April), this creates massive financing needs, while FX reserves are just slightly above USD 100bn. Therefore, Turkey is among those emerging economies – together with countries like Argentina, Brazil, and Indonesia – that could suffer severely in case of a sudden reversal of capital flows away from the EM asset class.

5. **Is there a risk of a recession?**

An outright recession next year cannot be ruled out, but it would imply a serious deterioration of the international backdrop.

A "sudden stop" as described above, i.e. capital flows to 'fragile' emerging markets drying up completely, combined with an economic slowdown in Europe would choke Turkish economic growth. Loan growth and private demand would fall and – even assuming additional fiscal stimulus – could trigger a drop in GDP. That said, this scenario is neither the consensus view nor our base case. While the consensus forecast for next year has come down in recent weeks by 0.4%, expected real GDP growth is still 3.7%, which – by the way – would still be the highest growth rate in Emerging Europe.

6. **Can we expect the backdrop for fixed income to start improving from here?**

In our view, it is too early to turn positive on Turkish fixed income and the currency.

The country's massive external imbalances, both in terms of flows (current account) and stocks (substantial foreign currency debt), have been the key drivers behind the widening of risk spreads – by almost 140 basis points to 430 bps – in the course of the year. Given the substantial refinancing needs over the next twelve months and considering the challenging international backdrop plus the government's tilt towards a heterodox policy stance, which is unlikely to change after the elections, we maintain a defensive position. On the side of hard-currency instruments our exposure is dominated by bonds with a short time to maturity and low cash-prices.

Local-currency bonds as well as the Turkish lira have seemingly reached attractive levels in the meantime. The real effective exchange rate has fallen more than 20% over the past two years and is at a historically very low level. At the same time, real interest rates are in the 4% to 5% range, which is high both relative to the country's own history and in comparison to its EM peers. However, risk premiums still look justified in our view and may even widen, given current economic uncertainties. Further fiscal expansion in support of longer-term growth targets (or near-term politically motivated election promises) cannot be ruled out, while a slowdown of global liquidity growth together with Turkey's external imbalances and inflationary pressures could push domestic rates higher.

We are prepared for such a scenario and maintain a cautious stance towards the Turkish lira and local currency bonds.

7. **At the time of the election, the Turkish stock market hit a bottom. Can we now expect a rebound?**

Not necessarily, because sentiment-driven gains may be short-lived, and, for a non-domestic investor, currency movements could eat up any local index gains.

Political risk has improved as a result of the election, and it could improve further in case the emergency law were to be lifted and the formation of a government sent some reassuring signals to investors. Therefore, a relief rally could happen, given the market's dismal performance in the year to date.

In this context, it is tempting to point to the market's performance after the presidential referendum in April 2017, when the Istanbul equity index gained 30%+ in USD-terms within five months. However, the situation is different now. Back in 2017, the sentiment towards EM equities in general was positive. This year, the entire asset class is struggling. Second: The economic momentum in Europe – Turkey's most important export market – peaked in 2H 2017 and has been slowing since. Third: domestic activity indicators improved during 2017, while they have softened this year. And finally, the country's imbalances – trade balance, budget, inflation – have deteriorated over the past twelve months, pushing up interest rates and limiting the government's possibilities to provide further stimulus.

Unsurprisingly, in light of these developments, the Turkish market shed about 30% in TRY terms and c. 35% in USD terms from the beginning of the year to mid-June. As a result, the market is now trading on just 7x forward earnings, which is the lowest valuation since the financial crisis, implying a discount of 45% to the average of its EM peers – more than double the average figure over the past ten years.

Given the country's longer-term attractions – including favourable demographics and a successful, very competitive export-sector – current valuations look like an attractive entry level. That said, given the macroeconomic issues described above and the risk of further policy blunders, there is no guarantee (there seldom is one in financial markets) that entry levels could not even get lower. Consensus earnings growth in 2018 is positive but well below consumer price inflation, and in recent weeks earnings revisions have trended lower.

In our dedicated Turkish fund, we have adopted a defensive stance, reflected in a portfolio beta vis-à-vis the broad market index of 0.8 and in a higher cash position than usual. In terms of sector allocation, we tend to be cautious on banks, which usually suffer during times of macroeconomic stress, and focus on export-oriented manufacturing stocks.

8. **Next events to watch:**

- Announcement of new cabinet expected during the week starting July 9
- Lifting of emergency law July 19, 2018
- MPC meeting July 24, 2018
- Inflation report End of July 2018
- Budget proposals for 2019 October 2018
- Municipal election March 2019

Legal note:

Prognoses are no reliable indicator for future performance.

Peter Szopo

Peter Szopo has worked as chief equity strategist at the Erste Asset Management since March 2015. Before he already worked as a consultant for equity fund management at Erste Asset Management for Central and Eastern European equity markets. From November 2009 to April 2013, he was head of the research department at Alfa Bank in Moscow.

After his research work at WIFO (Austrian Institute of Economic Research) from 1978 to 1990, he worked as a securities specialist in various management functions at internationally renowned investment banks. During this time he held the position of Head of Research at such institutions as Creditanstalt Investmentbank, UniCredit Bank Austria, Robert Fleming Securities, and at Bank Sal. Oppenheim.

Along with his analysis activities, he worked from 1997 to 2000 at Eastfund Management as the fund manager for Central and Eastern European equity.