Strategy Outlook I JANUARY 2015

2015: No need for a breather

TEB Asset Management

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

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Non Independent Research - Marketing Communication

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Executive Summary

Leaving a good year behind, in terms of nominal returns, we are looking forward to another promising yet undoubtedly volatile year ahead. In 2014, MSCI EM performance was surely disappointing. Yet, there were quite a few standouts that delivered quite lucrative yields within the EM context and the Turkish market was one of them. Given strong growth of the US economy, hence strong USD, and rather varied impact of low commodity prices on EM, we believe that EM as an asset class may struggle in delivering returns. And, yet, once again, we preserve our conviction that Turkey will decouple from EM as it did in 2014.

We highlight couple of reasons why this is the case from top-down/macro point of view such as; i) oil price bonus on commodity importers such as Turkey, ii) diminished risk of committing monetary policy error due to FED threat, iii) expected improvement on inflation and progressive healing on the C/A deficit, iv) rekindled push for structural reforms once election cycle is over by June, v) vigilant fiscal management supported by both macro prudential measures and budget discipline, vi) new opportunities arising for Turkey in its ambitious role as energy transit hub, vii) room for better economic growth once subdued private investments bounce back thanks to improving local & global economies.

Undoubtedly, we will witness a volatile year ahead marked by FED's timing & size of prospective rate hikes. For various reasons such as, diminished "home bias" of DM funds and more diversified sources of funding, balancing impact of ECB & BOJ policies, improving but not overheating US economy and sticky negative "term premium" that will cap US 10 year yields, we believe that any FED-induced volatility/market hick-up would be short-lived, posing opportunities for seasoned EM fund managers to deliver alpha.

We are constructive on the currency front as we believe that two sources of vulnerability, i.e. large current account deficit and high private sector f/x debt, are manageable and funding would not be a concern. Hence, as long as the monetary policy is in line with the market realities, any currency hick-up would thus be short-lived.

All in all, we draw a rather benign macro picture in which we are looking at a real growth of 3.5%-4%, average real interest rates of 1%-2% and a year-end CPI of 6.5% - 7%.

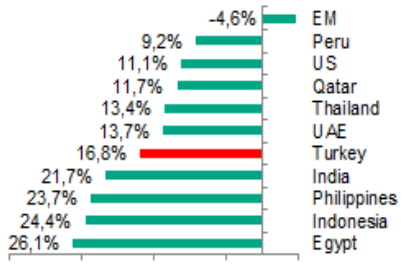
On the equity front, we are cautiously optimistic as well. We believe that volatility may increase towards mid-2015 coincidental with the FED's potential liftoff, Turkey's general elections and possibility of Russian sanction removal. Considering low level of interest rates and Turkey's improving macro fundamentals, it should not be a surprise that Turkey's PE discount gap to EM peers to narrow down substantially in 2015E. One condition for that as we see is for Turkey to stick with its structural reforms and market/business-friendly rhetoric with inclusive policies. Otherwise, any windfall gain on low oil prices and improving inflation dynamics would likely be squandered with only temporary gains.

On fixed income, we are looking at a year where the yield curve may remain inverted or at best flat, at least at the onset of the year, as we believe that the Central Bank of Turkey would not be in a rush to cut rates. We believe that as long as US-10 year yields allow, Turkish bond market can trade at a narrow band with 1% to 2% real returns on expected inflation. As happened in 2014, we expect corporate bond demand to remain high.

What happened in 2014? What next?

2014 was quite volatile for the EM. We started the year with heightened concerns on domestic politics, tension in our neighbors that followed sharp depreciation of the TL and emergency rate hike by the Central Bank of Turkey. Yet, over-pessimism paved the way to opportunistic positioning later on and we witnessed positive returns in all EM classes by the end of 1H2014. In 2H2014, EMs faced another round of volatility on the back of strong US economic data, rally in the DXY index and short-lived spark in US 10-year rates. Overall, looking back at the year passed by, as Turkish asset managers, we are content.

Chart 1: 2014 Top 10 Equity Returns (USD)

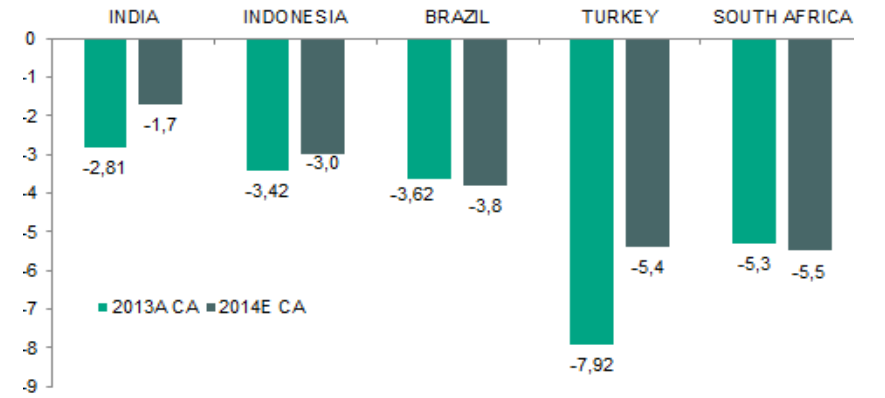


Source: Bloomberg & TEB AM Research, Dec'14

In 2014, Turkish equities performed superbly well with 17% USD-based gains or 22% outperformance vs MSCI EM. The bond rally was spectacular with benchmark bond yield peaking at 11.6% by March came down below 8% by 2014-end. The TL against equal weighted currency basket almost remained unchanged with minor nominal depreciation, yoy.

This was not just pure luck. In fact, what we preached about beginning of the year has mostly been realized. Back in late 2013, we argued that 2014 would a crucial year to prepare for even tougher 2015 and the winner of the EM's ugly contest would be the one that most healed its macro vulnerabilities in the form of reduced need for short-term external flows, lower inflation and prudent policy making. While inflation scorecard was not great, Turkey has delivered the most impressive improvement in healing its C/A deficit within 2014 among "Fragile Five".

Chart 2: Fragile Five C/A deficit (% of GDP)



Source: Bloomberg & TEB AM Research, Dec'14

Now looking at the year-ahead, we identify that certain themes will remain intact such as;

- strong USD,
- loose monetary conditions in Eurozone & Japan,
- subdued inflationary pressures in DM economies due to sub-par growth and low oil prices,
- volatility induced by the expectations on timing & pace of FED hikes

Certain themes have emerged new such as:

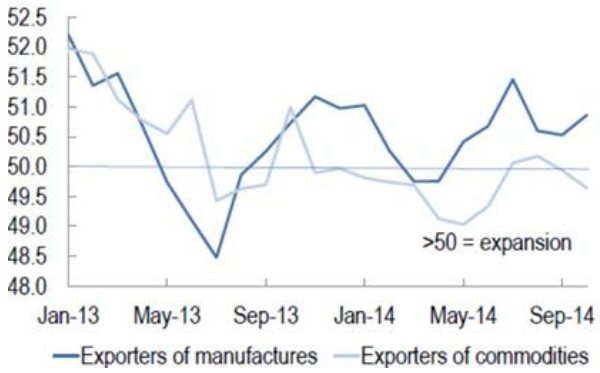
- divergence in growth & inflation trend among the DM markets and rather convoluted mechanisms on currencies,
- commodity trend will continue to create a definite facture among the EM countries,
- ECB's increasingly more aggressive role in inducing inflation (& growth in EM countries)
- Russian contagion or risk of big defaults
- Slow-down in Chinese growth momentum

Why should Turkey stand out amongst the EM in 2015?

Given strong growth of the US economy, hence strong USD, and rather varied impact of low commodity prices on EM, we believe that EM ugly contest will continue also in 2015. And, once again, we preserve our conviction that Turkey will be the winner of the ugly contest. Here is why:

- **Turkey is not a commodity exporter:** As we underlined in our 2014 Outlook piece, this is a very simple yet a very powerful fact. This simple fact alone takes Turkey apart from Brazil, South Africa or Russia the countries, which heavily rely on upcycle in commodities. As we wisely predicted, oil bonus has become a huge game changer especially in Q42014. We expect Turkey will continue to reap the benefits of low energy costs throughout 2015 even though we expect that oil prices would average out at around USD80/bbl vs current spot of USD55/bbl.

Chart 3: PMI – Manufacturers vs. Commodity Exporters



Source: Citigroup"Prospects for 2015 & Beyond", Dec'14

Table 1: CAD – Manufacturers vs. Commodity Exporters

	Commodity exporting	Manufactures-exporting
Current Account Surplus	• Russia • Nigeria • Venezuela	• South Korea • Hungary • Israel
Current Account Deficit	• South Africa • Brazil • Indonesia • Peru	• Poland • India • Turkey

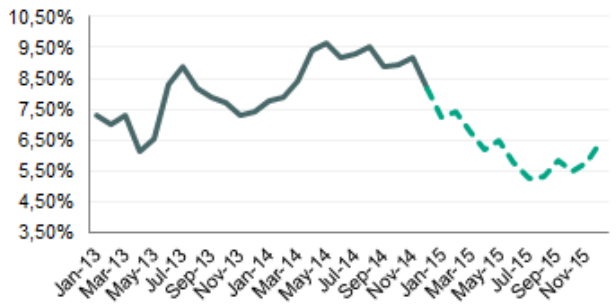
Source: Bloomberg & TEB AM (for Turkey), Dec'14

- **Risk of committing monetary policy error diminished:** Beginning of 2014, the Central Bank of Turkey (CBT) was blamed to be overly dovish, thus, committing a policy error. Indeed, we ended up with a substantial rate hike in the very beginning of the year in order to hinder free fall of the TL. Come 2015, the CBT sounds rather cautious and more focused on the inflation outlook. In a year when we will discuss more and more of FED's tightening prospects, it is only wise for the CBT to remain on its toes and ready to act during times of heightened volatility. We believe that the market forces will push the CBT to be more vigilant this year and become dovish only when inflation expectations improve and FED risk eases.

- **Inflation and C/A deficit will be major improvement items:** Even under conservative expectations of non-energy imports increase (by around 5% in USD terms) and export growth momentum to stall dramatically in 2015E, we would see very significant gains of oil price decline on trade balances. Our calculations suggest C/A deficit to come down below USD40bn or around 4.7% of GDP (down from this year's estimated 5.4%). In case non-energy imports stay flat in USD terms, yoy, C/A deficit can fall down to USD31bn or 3.7% of GDP. Yet, we do not believe that this situation is realistic. Our conviction on current account deficit coming below 5% is not yet shared by the consensus as 6 international brokers estimate 2015E C/A deficit of 5.2% with only a slight improvement to 2014E.

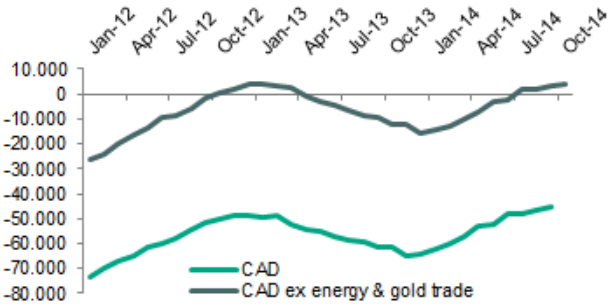
On the inflation front, we calculate that there is room for inflation to come down to 6.5% (or even below 6% in mid 2015E). Our expectation for 2015E energy inflation even under USD80/bbl. oil price assumption is actually 4.5% as we do not expect any downfall in natural gas prices and pump prices will not reflect drop in crude price on a one to one basis due to weight of Special Consumption Tax on the pump prices. The key benefit from inflation in 2015E will actually come from 2 sources other than energy; i) due to adverse weather conditions impacting crop supply, food inflation became 12.7% vs headline inflation of 8.17%. Expecting that supply shock will not be as severe, we would expect food inflation to be around 7.5% (or some 110bps lower than its historical 2009-2013 average and some 500bps lower than 2014E inflation), ii) Currency depreciation that jacked up inflation in early 2014 will not repeat itself and provide benign base-year effect.

Chart 4: Turkey CPI (y-o-y, %)



Source: CBRT & TEB AM Research, Dec'14

Chart 5: Turkey Current Account Deficit (in USD mn)



Source: CBRT & TEB AM Research, Dec'14

- **Push on structural reforms:** We believe that EM economies will increasingly be tested by their policy tools and their efforts to implement structural reforms in order to put economic growth back on track. Hence, we are believers of sustained "divergent" performances among the EMs. While the key differentiating item would be commodity import/export dynamics, post-2015, during full course FED liftoff, the countries that take solid steps in attaining structural transformation would be rewarded by the markets. In this context, we have analysed the structural reform progress of three promising reform countries; Mexico, India & Turkey:
  - Mexico's reform agenda aims increasing Mexico's productivity & competitiveness. The key steps taken would be privatization of TV networks, breaking energy monopolies and improve infrastructure to better tap US shale gas boom.
  - India's reform ambitions are more widespread and perhaps the most difficult to implement. The reform agenda aims to decrease corruption/red tape, modernizing infrastructure, providing coherent safety net and financial inclusion of the households and most importantly providing employment to some 1mn young Indians entering to work force every month.

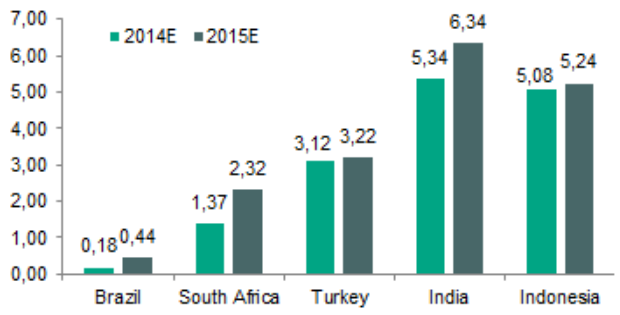
- Turkey's own reform agenda also aims at increasing competitiveness and better allocation of resources in the economy. Turkey, too, aims to improve infrastructure backbone, incentivize use of indigenous sources in manufacturing/energy and become a more globally open economy by increasing share of exports in GDP and enhancing financial sector backbone.

In the end, all these three countries aim to increase competitiveness and enhance credit channels to domestic SMEs. Implementing structural reforms that will be fruitful will prove equally difficult for all three. In terms of privatization/deregulation, Turkey is one step ahead of Mexico & India. However, judging by the market perception that is reflected on the price multiples, the markets are happy to give benefit of doubt to the reform agendas of Mexico & India while Turkey's own prospects fall into deaf ears even though there is a proven track-record of Turkey in implementing rather difficult structural changes. We believe that it is up to actual steps taken by these countries that will determine course of the fund flows, yet, we are hopeful on Turkish policymakers' commitment on the reforms.

- **Benefits from new energy game:** We understand that the current stance of the policymakers is to cement Turkey's role as an energy transit hub in an increasingly turbulent region. The latest move by the Russia in scrapping South Stream for a prospective one through Turkey, suggests that Turkey is in the midst of energy game between Russia & Europe. Once all the prospective pipelines completed, at full capacity utilization, Turkey would be able to transport 59bcm to Europe (49bcm from Russia and 10bcm from Azerbaijan plus 6.6 allocated to Turkey) increasing share of Turkey-transported natural gas to 11% from negligible amounts. Assuming some of the gas would displace Ukrainian transport, Turkey can replace Ukraine in importance in European gas transport (Ukraine accounted for 15% of European consumption in 2013). Furthermore, there is also a more distant possibility of Israeli gas to be pumped through Turkey while currently Israel is favoring a pipeline through Cyprus and Greece, instead of Turkey's lower-cost alternative.
- **Tough stance on fiscal policy and macro-prudential in place:** In 10-months in 2014, Turkey's Current Account deficit improved to USD33bn vs USD52.6bn of same period 2013. Of this USD19.4bn improvement, yoy, some USD11.6bn was stemmed from improvement in non-energy imports and rest from decline in gold imports. As such, throughout 2014, we have not yet seen any substantial benefit due to lower oil prices. We believe that such improvement in non-energy imports is particularly owed to macro prudential measures that capped excessive consumption. While it was a bold move to cap consumption (hence growth) in a double election year, it worked quite well to the benefit of trade balances. In 2015, we expect these measures to remain in place perhaps coupled with certain amendments that would incentivize exports or import substitution measures.

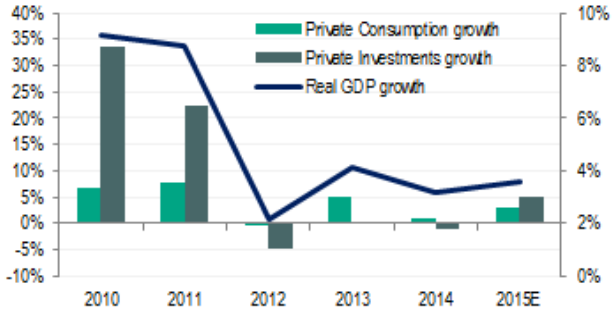
- **Growth estimates remain cautious with room for upward revisions:** Current expectations suggest that Turkey's 2015E growth outlook is no different than our selected EM peers. On CEEMEA, Turkish growth looks enviable given expected recession in Russia. However, analyst consensus forecasts suggest improving growth outlook for South Africa and India while Turkish growth outlook is expected to remain subdued. The key assumption in painting a rather uninspiring growth picture for Turkey is that due to current account problem the domestic consumption may not elevate as much while private investments will continue to remain subdued since 2012. While we agree that boosting consumption eventually dents Turkey's macro health, after a long dry spell, private investments should be able to start contributing to the growth profile of Turkey. Looking at the share of investments within GDP, Turkey's consistent improvement between 2002-2007 has been stalled since then. However, it is essential that the investments should pick up again in order to pave the way for sustainable (and more aggressive) growth path in the medium-term. Hence, it would be crucial for us to see structural reforms and investment incentives to encourage private investments. Even a moderate improvement (say 5% real growth on top of 2014/2011 decline of 7.1%) would be able to push GDP growth above 3.5% in 2015E.

Chart 6: Real GDP Growth Expectations in Fragile Five



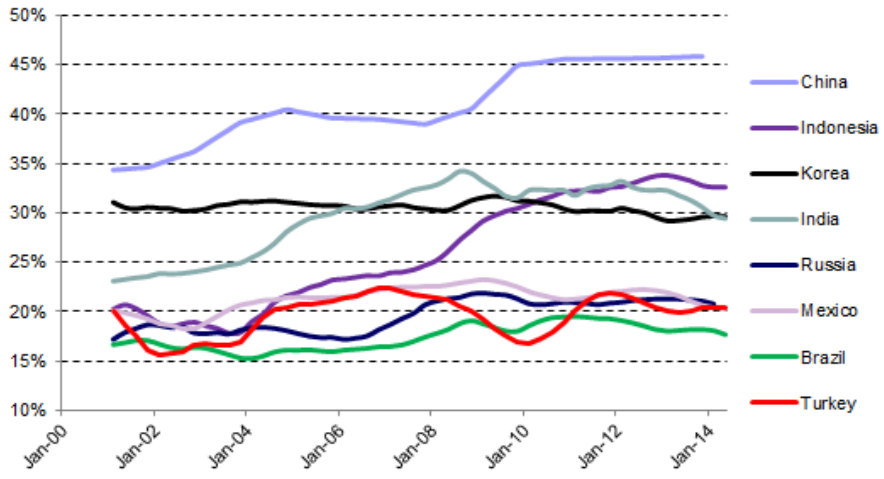
Source: Bloomberg Estimates & TEB AM Research, Dec'14

Chart 7: Turkey Growth Components



Source: Turkstat & TEB AM Research, Dec'14

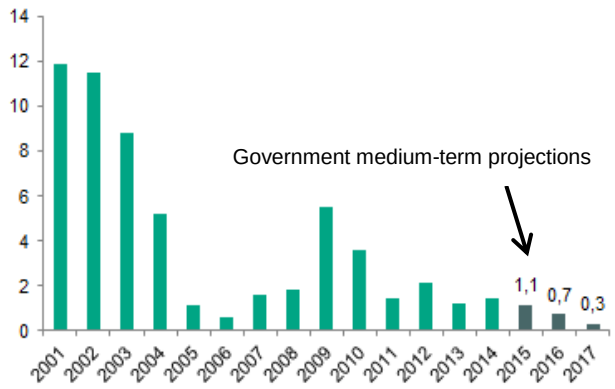
Chart 8: EM7 Investment share of GDP since 2000 (%)



Source: IMF International Financial Statistics &Credit Suisse research, Dec'14

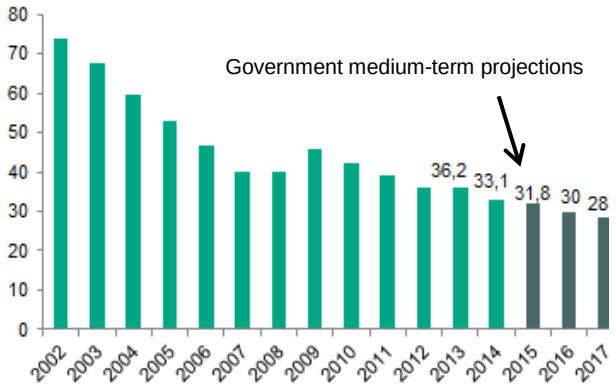
- **New medium-term programme does not suggest any major fiscal expansion:** Looking at the track-record of the government, fiscal discipline was sacrificed in a meaningful way only in 2009/10 in order to give a boost to the economy following global financial crisis. Even during election years, we have not observed a major deterioration in budget balances. Going-forward, the budget deficit is expected to be curtailed to an ambitious 0.3% targeted for 2017E according to the government's medium-term projections. Such improvement is expected to carry government debt to GDP below 30% again in 2017E. While we have our own doubts on the magnitude of such improvement, it is encouraging to see that the government is sticking with budget discipline.

Chart 9: Turkey Fiscal Deficit to GDP (%)



Source: Turkish Government Medium-term programme, Oct'14

Chart 10: Turkey Government Debt to GDP (%)

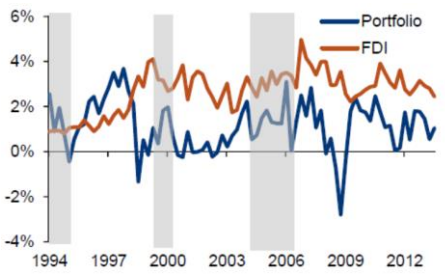


Source: Turkish Government Medium-term programme, Oct'14

What are the risks?

- **US rate hike:** As FED approaches to its tightening, whether it happens in June or late 2015, it is normal to expect heightened volatility in the markets. Yet, on balance, we think that US monetary tightening would be moderate and its repercussions on EM capital flows would not be as detrimental. As every other strategist suggest, there is a historical negative correlation on US monetary tightening and flows to the EM. [1] We see five key arguments why EM flows may not shrink as much:
  - First, we believe that the pace of tightening would rather be slow as wage inflation is not pushing FED as yet and overall headline inflation figures are benign thanks to oil bonus. Essentially, if FED is forced to hike in order to hinder over-heating of the US economy, this would not necessarily be a bad sign for the global economy as what is missing because of lack of sufficient portfolio flows to the EM can be replaced by FDI to the manufacturing EM countries if the global & US growth indeed takes off. In fact, during the latest tightening cycle of 2Q04 and 2Q06, portfolio & FDI inflows to the EM has increased only to be reversed following the financial crisis.
  - Second, the US's tightening move would be matched by monetary expansion in the ECB & Japan. Having said that , we are well aware that FED's moves would have a more pronounced impact than ECB or BOJ at least in creating sentiment against EM assets. Our thinking is that in a low-growth low-inflation environment the odd one, aka the one that tightens, would face currency repercussions and it is not clear at what extent FED is comfortable about the strength of the USD.
  - Third, following May'13 taper-tantrum, the monetary policies across the EM has become more coherent after facing wild girations on bond rates and rapid depreciation of the currencies. We believe that the "FED threat" would keep Central Banks on their toes and policy errors could be less common. In this context, we do not see that Turkish Central Bank is in rush to ease rates despite positive impact of lower energy prices on inflation and C/A deficit.
  - Fourth, as very well exemplified by the strategy change in Japanese pension fund's investments that would increase EM exposure in principle in lieu of Japanese assets, "home bias" of the DM economies might have diminished in recent years. This may be reasoned by yield seeking behavior and rather lackluster returns in home/DM markets. This is the key bull argument backing carry trades.
  - Fifth, thanks to expanding financial markets/institutions, commercial banks are no longer the ultimate source of funding. Sovereign and hedge fund exposure has increased rapidly which are less sensitive to the cost of funding increases in the US.

Chart 11: Emerging Market Fund Flows



** Shaded regions indicate policy tightening*

Source: BofaML Global Strategy "Have no Fear", Dec'14

[1] Citi Research Economics, Emerging Markets Macro and Strategy Outlook, "Prospects for 2015 and Beyond"

All in all, any FED-induced volatility/market hick-up would be short-lived, posing opportunities for seasoned EM fund managers to deliver alpha.

- **Currency, currency, currency:** If we are wrong in thinking that US rate hikes would not be as detrimental, the first shoe to drop would be the EM FX. The Turkish Lira's vulnerability would then be the key discussion point. Why Turkey is vulnerable? Because of its (relatively) large current account deficit and external financing needs. We are more confident on the C/A front at least for 2015E as we believe that the macro prudential measures will continue to help out curbing non-energy deficit while lackluster trend in oil prices will help on the energy front. Hence, let's look at the Turkey's external financing needs:

  - The pace of growth of external debt is definitely worrisome as external liabilities grew by almost 5x in the past decade, outpacing underlying economic growth in the country or 2x USD-based GDP growth.
  - Turkey's short term external debt stock stands at USD169bn as of October-end. Of this number, USD115bn is owed by the banks (including their offshore deposit base), some USD5bn is owed by the Public Institutions including the Central Government, USD1.5bn is owed by the CBT and the rest (or USD47bn) is owed by the non-financials. If we exclude offshore deposit base of the banks (assuming they would be rolled-over easily and holders of the offshore deposit base may not necessarily be foreigners), net external short-term debt stock becomes USD145bn (or 18% of GDP) and bulk of this is channeled to the Turkish economy via banks. In fact, Turkey's well-articulated some "USD200bn external debt problem" is this number + some USD40bn Current Account deficit incurred annually.

  Yet, we doubt that external debt number is at excessive levels to trigger a sustained fx liquidity crisis.Here below we elaborate on why such risk is rather manageable:

  - Bulk of the external liabilities owed to European & UK institutions. Yet, Turkey's exposure to European banking system is only 1%. Thus, if the European QE takes place, liquidity would not be a concern but Turkey's main weakness would be the re-pricing of liabilities.
  - By regulation, the banks are not allowed to take short fx positions and carry fx risks on their own B/S and they are not allowed to channel fx debt to TR-earning retail households. The only fx exposure of banks would be via trade channel (or some USD30bn trade financing needs) or by extending loans to fx-earning non-financials.

- When we dissect the foreign liability exposure of the non-financials, we see that manufacturing sector exposure is 40%. Essentially, any f/x debt channeled to manufacturing sector would be presumably backed by fx earning capabilities, hence, it is essentially the exporters that take on fx debt. What is more remarkable is that rest of the balance or some 60% goes to the service sector, particularly to the transportation, R&D and construction. Given heavy infrastructure/transportation projects are undertaken with some form of government guarantees on income/cash flow side, we see less risk exposure on pure private companies but more risk on inflationary pressures as these projects would nonetheless be undertaken even at the expense of elevated government guarantees in case that the private sector fell short of its obligations. On R&D front, we believe that the largest recipient of the R&D driven projects is the army/quasi-government structures, hence, risk is on inflation or elevated price levels versus fundability of the projects. The construction sector is the riskiest one we see and this can also undermine consumer confidence if the credibility of the large construction companies comes under pressure. Hence, we would worry less as long as the construction activity continues unabated in the country.

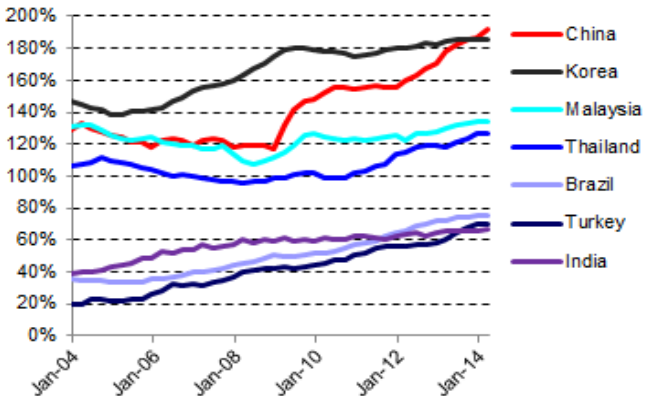
- **And politics:** In the aftermath of municipal and presidential elections, Turkish internal politics has been rather calm going into the general elections that will be held in June'15. Recent polls indicate that current distribution in parliament would not alter significantly. Nevertheless, we expect noise to increase especially in 2Q15 due to not only up-coming elections but also the elevated intensity of talks over Kurdish minority rights. Depending on the tone of the announcements, we could observe volatility in the market before the elections. Currently, the talks between the government officials and the Kurdish minority representatives have been ongoing and according to the government sources, the progress is speeding up.

  In our opinion, any sustainable improvement in Kurdish issue would be a significant game changer for the Turkish economy. In 2014, stars were aligned for the Kurdish minority not only in Turkey but also in Iraq, Syria and Iran. Their international profile rose higher in the eye of the western countries as a reliable ally against radical Islamist groups, while the Turkish government was criticized for turning a blind eye to the Western security concerns. Thus, for the Kurdish minority in Turkey, the general elections in June 2015 is the time to capitalize on the gains of 2014.

  In 2015, we believe additional risk from current situation in Syria, Iran and Iraq is minimal. We expect a less aggressive and more defensive Islamic State (IS). In Syria, Assad's forces and Islamic State could gain some ground against Free-Syrian Army (FSA), and in Iraq government forces would be more effective against IS. In this environment Turkey's trade could continue at current levels, a material improvement in US/Iran relations is an upside risk to our estimates.

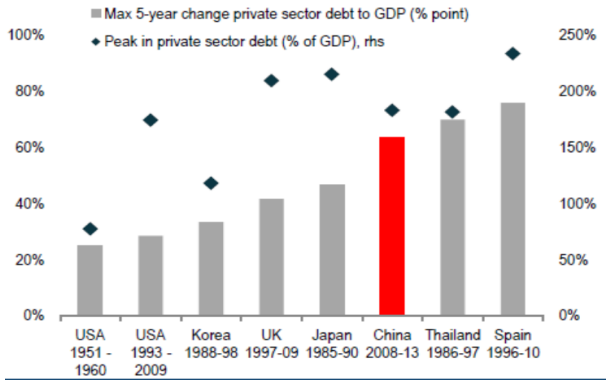
- **China weakness can be a major headache for EM (& commodities):** We believe that China's softening domestic demand and shadow banking restructuring would push POBC to be on the easing side. While Turkey's credit boom in FED QE years has become a major discussion and fragility point, it is actually dwarfed by massive credit boom in China. Hence, capital outflow from Chinese economy may trigger EM-wide volatility. To us, any China-induced EM fragility can take a toll on levered economies such as Turkey particularly from FX front.

Chart 12: Turkey vs. EM peers private sector credit to GDP



Source: BIS & Credit Suisse research, Dec'14

Chart 13: Credit Boom relative to GDP



Source: Credit Suisse, Global Equity Strategy "2015 Outlook: Equities, Regions

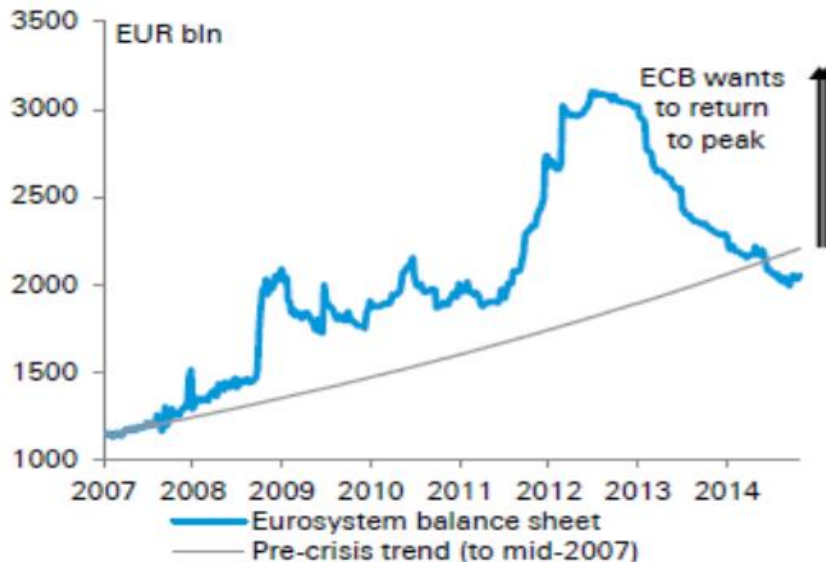
- **Weak(er) trade partners:** On the flipside of low oil prices, Turkey's main export trade partners may feel the pinch. Russia (together with the CIS) make up around 11% of Turkey's export base while MENA (including Iraq) has much higher 24% share. While MENA currencies are mostly pegged to the USD, Russian Rouble's recent free fall would weigh on Russian growth, pushing the economy to a recession. According to the Turkish economists[2], Russian economy's downfall may cost Turkey around USD3.5bn to USD4bn through trade, tourism and services channel or around 0.4-0.5% worsening of CAD to GDP ratio. However, we believe that if the oil prices remain sticky at USD55/bbl. (or at the current spot price level), improvement on C/A deficit due to lower cost of energy imports would well compensate for any downfall in Russian exports/trade.

  We believe that second derivative impact of the Russian crisis would be more important through European growth & liability angles. The economists argue that between Russia and Europe, direct trade links would jeopardize around 1% of Eurozone GDP. This is not a trivial figure given Europe is struggling to bounce back from deflation/recession turmoil. Exposure of Italy & France is more pronounced on Russian financial system and lingering sanctions against Russia can well jeopardize confidence within Eurozone economy as well.

[2] Finansinvest "The Slump of the Rouble: Implications on the Turkish economy and relevant stocks", Dec'14

- **ECB – A paper tiger?:** One of the crucial assumptions about 2015E would be ECB's prospective QE in order to save Eurozone from deflationary vortex. Public QE would not be able to solve euro area's growth problem, according the Deutsche Bank economists[3], as this would require fiscal/structural steps, but balance sheet expansion of Euro 1 trillion would be credible in fighting against lower inflation expectations. If the second LTRO proves disappointing (again), then the ECB President would be tempted to accept a smaller majority in order to deliver QE and this can happen as early as January 2015. According to Deutsche Bank, a 1 trillion euro expansion of the ECB Balance sheet would weaken euro trade weighted index by 10% or bringing EUR/USD parity down to 1.15. This would then create export competitiveness and imported inflation, serving well to the Eurozone economies. If the ECB fails to deliver such grand scale QE, we would still presumably see weakening of the euro as Draghi's speeches have been effective so far in keeping euro under pressure, but extent of euro weakness or its inflationary pass-through would then be debatable.

Chart 14: ECB Balance Sheet Expansion



Source: Deutsche Bank Research & ECB, Dec'14

[3] Deutsche Bank Research "World Outlook 2015", Dec'14

Equity strategy

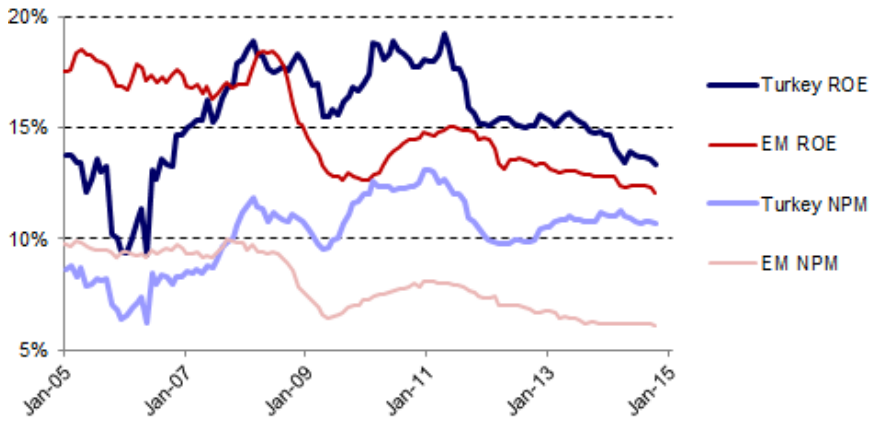
- We are fully aware that 2015 may pose a difficult environment for the EM portfolio flows given that i) conviction on EM growth is not as strong as US economic growth, ii) the USD strengthens against almost all global currencies, iii) Chinese slowdown risk emerges. While we are still believers of yield seeking behavior to continue with euro and Japanese yen can act as "carry" currencies, a risk off sentiment sparked by FED's unexpected/immature hawkish move, China/Russia contagion or geopolitical risks can hit EM currencies rather swiftly.
- Our Turkey macro base case scenario pillars on; i) a prudent Central Bank managing the market risks with both liquidity and i-rate weapon, ii) macro-prudential measures to remain intact, iii) TL gaining value in real terms albeit from a low base but not to an extend that would threaten C/A widening, iv) commodities to remain under pressure, v) end of easy money.
- We paint a constructive outlook for the Turkish market overall for the year. However, volatility may increase towards mid-2015 coincidental with the FED's potential liftoff, Turkey's general elections and possibility of Russian sanction removal. Any good news on the Russian front may curb the appetite for Turkish assets given vast valuation difference. In case the FED sits on its hand for the most of 2015, Turkish assets may enjoy "multiple expansion" as long as inflation and the Current Account behave in line with our expectations. The key marginal investor would thus be GEM funds as a spillover from their existing Russia/Brazil positioning in favor of Turkey. On EM relative basis, we are convinced that TR would continue its outperformance.
- Considering low level of interest rates and Turkey's improving macro fundamentals, it should not be a surprise that Turkey's PE discount gap to EM peers to narrow down substantially in 2015E. One condition that we see is for Turkey to stick with its structural reforms and market/business-friendly rhetoric with inclusive policies. Otherwise, any windfall gain on low oil prices and improving inflation dynamics would be squandered with only temporary gains.

How can equity market behave?:

- In 2014, the Turkish market's performance has been quite solid. In terms of MSCI Turkey index, USD based nominal return was 17% (or 26% TRY return in BIST 100 index) while EM outperformance was 22%. Among the Fragile Five countries, Turkey has come third after India & Indonesia in terms of equity market performance.
- Following a stellar 2014 behind, the key question is whether the Turkish market can repeat this again in 2015E. After all, as of late December, Turkish market trades at 10.2x 2015E above its historical median PE of 9x. Hence, on nominal performance terms, repeating 2014E we say it is difficult but nonetheless doable.
- According to consensus earnings expectations, the Turkish market can claim a cyclical peak multiple of 12.8x PE with another +20% TRY based return assuming current earnings expectations stay the same. Hence, in a bull-mode, such multiple expansion is quite plausible.

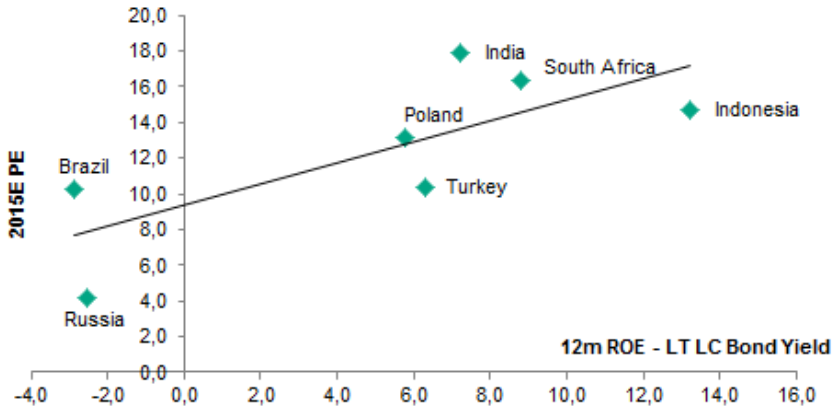
- Another catalyst that can move the market higher would be upward earnings revisions. Here our main focus would be on Turkish financials as they make 39% of the consolidated earnings of the market. The current earnings expectations portray 13.4%, yoy, earnings growth. This comes on top of flat earnings of 2014E. Hence, on 2-year CAGR terms, earnings are expected to grow by 7% -- definitely not demanding as in real terms this would actually mean contraction on the banks earnings potential. We believe that the analyst expectations err on the cautious side as stingy fee regulation and high-faring new NPL flows cast a doubt on earnings growth. On the other hand, we should remind ourselves that TR banks earnings potential was capped in the past two years with adverse provisioning changes, competition fines and deliberate adjustment to loan growth. While some of these limitations would prevail going-forward, assuming no one-off regulatory changes, 13% earnings growth is not demanding at all. Hence, such low-balling of earnings expectations actually give us comfort on the market's pricing.
- While asking the market to repeat its stellar 2014 performance in a potentially FED liftoff year would be too much, we are much more convinced in saying that Turkey's relative standing against other EM markets continue to be solid. Here is why:
    - **Turkish ROEs are on a better standing vs EM:** We believe that the Turkish market's risk-return profile is better aligned with its PE vs other select EM peers. On 12-month ROE and risk free rate (or 10-year local currency bond yield) differential as a crude measure of economic returns, Turkey stands on a better footing vs its level of PE. In terms of net profit margins, Turkish companies claim higher margins vs EM average as well.

Chart 15: Turkey versus EM: net profit margins and profitability (%)



Source: MSCI & I/B/E/S & Credit Suisse research, Dec'14

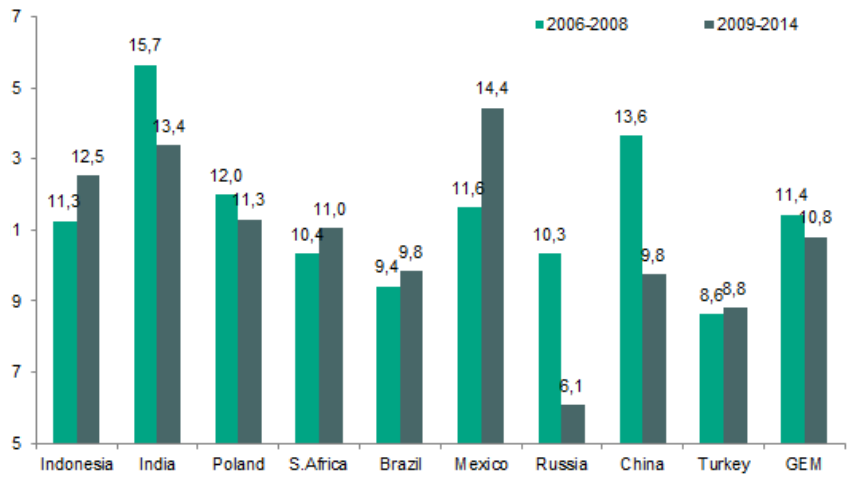
Chart 16: Economic value vs. P/E



Source: Bloomberg & TEB AM Research, Dec'14

- **Turkey's historic premium to PE is well deserved:** One common question that we get on EMs is their relative expensiveness versus their own history. One potential answer to this was that loose monetary conditions post Lehman collapse led to multiple expansion in the equity markets globally which should revert back to pre-2009 levels. However, this argument does not hold water as Pre and Post PE multiples differ widely within EM space as the countries/economies that are reliant widely on economic growth witnessed multiple compression such as China and Russia. In the case of Turkey, we cannot really talk about a significant PE expansion before and after FED QE.

Chart 17: Pre (2006-08) and Post (2009-14) Median Forward Looking PE Multiples



Source: Bloomberg & TEB AM Research, Dec'14

- Yet, it is undoubtful that massive monetary expansion in the world caused bond yields to tank post 2008. If we look at Turkish bond yields, it is quite striking that bond yields corrected massively on the back of global liquidity wash and declining inflation rates. On this basis, we find Turkey's historic PE premium even more meaningful and well deserved. On a simple analysis that takes cost of equity as a local bond yield (plus market risk premium of say 5%) and assuming actual earnings growth of 2014/2011 will also hold in the future, change in bond yields between now and 2006/08 average should imply tripling PE for the Turkish market while India and China trades deservedly below their historical PE averages. This gives us comfort that Turkey's premium to its historic PE is by no means stretched.

Table 2: Median Bond Yields Pre & Post QE Era

	2006-2008 Local 2-year Bond yield average (%)	2009-2014 Local 2-year Bond yield average (%)	Current 2-year LC Bonds (%)	Change pre/post FED QE yield
Indonesia	9.82	6.61	7.38	(3.21)
India	7.50	7.38	7.88	(0.12)
Poland	5.30	4.08	1.76	(1.22)
South Africa	8.98	6.32	9.13	(2.66)
China	2.80	2.83	3.29	0.03
Turkey	20.64	9.09	8.20	(11.55)

Source: Bloomberg & TEB AM Research, Dec'14

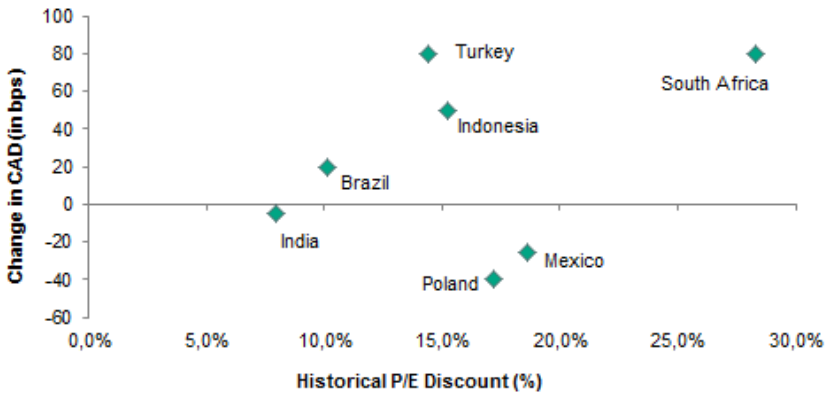
Table 3: Implied multiple expansion benchmarking bond yield change

	Change pre/post FED QE yield	Implied Multiple Expansion	2015 PE Premium over to 2006-2008 Average
ndonesia	(3.21)	37%	31%
ndia	(0.12)	-24%	-8%
'oland	(1.22)	52%	3%
outh Africa	(2.66)	-2%	24%
hina	0.03	-13%	-28%
urkey	(11.55)	234%	14%

Source: Bloomberg & TEB AM Research, Dec'14

- **Relative PE vs current account deficit looks much reasonable:** Given EM FX is the main risk factor, we believe that comparing relative PE discounts (versus the countries own averages) with expected improvement on Current Account deficit (i.e. the main fragility factor given the currency troubles) looks meaningful to us. In that context, Turkey's relative PE premium does not look as demanding given large expected improvement in the Current Account deficit.

Chart 18: Change in CAD (2014 – 2015E) & Current P/E Premium/(Discount) to History



Source: Bloomberg & TEB AM Research, Dec'14

- **Turkish Lira is relatively more immune against the USD strength:** Another point that we would like to draw attention to is the fact that Turkish Lira's correlation to the USD strength is weaker (but still unfortunately negative). Hence, on a EM relative standing, Turkish asset should continue to do well and attract GEM investors.

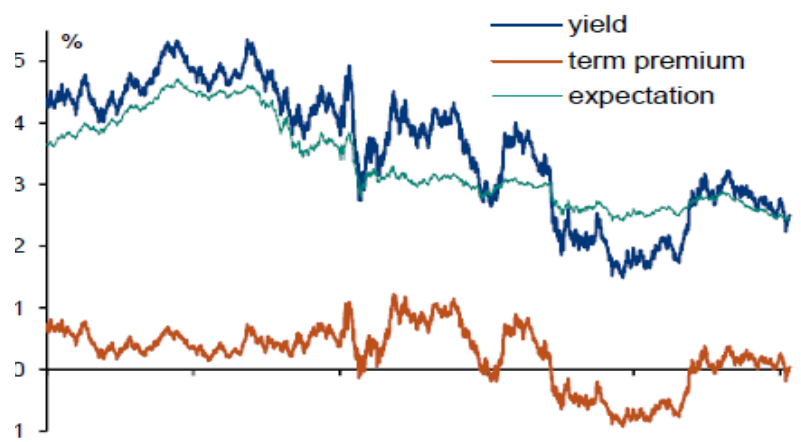
Equity sector positioning

- In 2014, the best performers of the year were the companies with commodity exposure on the procurement front. Steels, Eregli Demir Celik and Kardemir, performed superbly, chemicals, fertilizers & tire manufacturers did also well. The consumer stocks performed OK except for the retailers and food manufacturers that were hit by high domestic food inflation. What performed the worst were the companies with Russia & Frontier market exposure perhaps due to heightened worries of geopolitical risk spread out. Financials started the year with a very weak outlook due to currency tension and perceived weakness of the Central Bank, yet, post March, relative performance took off.
- In 2015, when we look at the PE of the Turkish companies vs EM peers, we see that Materials demand hefty multiples given Russian market, home of the steels, trade low. Given China's slowdown would be debated more and more in 2015, we believe that we need to be selective on Materials.
- On a weak commodity outlook, the companies that have local pricing/branding power with commodity-related cost bases can do well on a relative basis. We believe the stocks like ARCLK, CCOLA and auto companies fit the bill. Aviation stocks can also enjoy a good at least for the first half of the year thanks to low oil cost and high base year impact.
- While we do not expect construction activity to put on brakes as evidenced by construction permits issued in 9M2014, real estate prices have surpassed nominal GDP growth let alone CPI since 2010. We hear rather confusing news from government front in terms of taxation of real estate returns. We doubt that there would be a radical adverse regulatory pressure on the sector, it is quite plausible that the law makers would try to disincentivize speculative home buying. Hence, stock selection would be the key in allocating resources to the construction sector. On building materials, the cost push should be benign hence building materials may be continued to be favored over to the real estate.
- On Financials, we hear concerns on NPLs and limited venues to earn cost of capital given compressed bond yields. Furthermore, spread between deposit costs and bond yields may remain wide as deposit growth requires real yields. Hence, the banks that have less reliance on deposits either due to easy access to wholesale funding or ample equity cushion should perform well.

Fixed income strategy

- **Monetary policy to be cautious rather than dovish:** We expect central bank to follow a rather cautious monetary policy. We believe that FED's potential liftoff would continue to act as Damocles' sword against the sovereign Central Banks' moves globally, hindering them being overly loose/confident on monetary policy given currency depreciation risks. Furthermore, given that the election cycle will be behind us after June'15, economic rationale may overcome any politically-induced moves. In this context, we expect the bank's focus would continue to be on the TRY's value and on inflation. We observe that the Central Bank has regained its credibility by not getting overly excited on the back of oil bonus for the Turkish economy. It would be wise to cement this credibility by being cautious until inflation behaves.
- **Believers of low(er) inflation:** As our inflation outlook is rather constructive, we are not favoring CPI linked products at any maturity. The linkers will continue to be "held-for-maturity" instruments; hence, liquidity will continue to be tight as well. We also see an anomaly on what CPI-linker prices in as 2015E inflation expectation (6.51%) with what the Central Bank survey suggests (or 7.21%). This means that capital gain on CPI linkers may prove to be slim.
- **Term premium to remain negative:** We are constructive for both domestic and foreign currency Turkish fixed income instruments for the long-term maturities. The key reason for this is that as the FED tightens the short-term rates will respond to it, yet, carry-flow may as well keep UST10 rates under pressure, further extending negative term premium. In itself, for the US housing market, low long-term yields would bode well, hence, FED may not necessarily step in to terminate term anomaly at least for the course of 2015. For the Turkish market, as long as US 10-year yields would continue to serve as a proxy, yields may remain low on the long-end while short-term rates would be susceptible to tight market conditions. Thus, we expect an inverted yield curve in 2015. Furthermore, for the long-end of the Turkish yield curve, improving macro outlook (in terms of inflation and trade deficit) coupled with no major change in global liquidity conditions (thanks to ECB put and ultra-dovish BoJ) can pressurize the long end of the curve.

Chart 19: US term premium remains negative



Source: BofaML Global Research, Dec'14

- **Scarcity premium on TR bonds:** In 2014, roll-over ratios of Turkish treasury could attach some scarcity premium to the curve. Over the years, we see steady decrease in the Turkish treasury's roll-over ratios. In 2015E, the Treasury's targeted roll over ratio is 82% on the domestic currency and this means TL 19.3bn less issuance (or 4.2% of the total domestic currency denominated bond market).
- **No major hick-up on Turkey's risk perception, hence, benign CDS spreads:** On the Eurobond front, we believe CDS spreads have more room to decrease. In a bullish scenario, there can be a case where Turkish CDS spreads converge to that of Mexico. Of course, this time around Mexico's trade (hence currency) dynamics look a tad better than Turkey as the currency of its main trade partner, US, strengthens as opposed to weak Euro in the case of Turkey. However, as long as structural improvements go in track, Turkey-Mexico spreads can narrow from current 83bps level (5-year low is 13bps), creating upside in the mid-to-long end.
- **Corporate Bonds will continue to be everybody's favorite:** In 2014, total corporate bond issuance was 69.4bn in TL terms while the total bonds outstanding as of December 2014 is TRY45.4bn. In FX denominated corporate bond market, the new issuances in 2014 was USD14bn. In terms of annual growth in new issuances, 2014 definitely forms a peak with 19% growth in TL bonds and 23% growth in the FX denominated bond market (in USD terms).
- To put these numbers in context, if we assume that Turkey's overall external funding need is USD200bn in a given year, fx-denominated corporate bond issuances make up 7% of this. There is clearly more room to tap here. Hence, we expect the corporate bond issuances both domestic and foreign currency would continue at a swift pace. We expect corporates to finance CAD going forward with over 100% roll-over rates, but depending on the levels of US interest rates, we may see certain escalation in Turkish rates.

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