Ground Control to Major Tom…

The month of February will probably be viewed, in retrospect, as a time when the somewhat excessive exuberance of the preceding months subsided and a sense of realism pervaded the market. But isn't that generally the case anyway: hopes that turning the page to a new calendar year will usher in earth-shaking shifts give way, all of a sudden, to the realisation that economic trends do not change all that quickly. There is nothing disconcerting about that, though… **It could even be considered a healthy correction, as it might pave the way for favourable market trends to be based on more solid foundations**.

A similar pattern is already evident in global markets: the year started with expectations of an overall recovery, which promptly reflected on long-term bond prices, while stock exchange indices started testing 5-year highs… However, judging from the significant asset price gyrations, **no decisive market trend seems in place for now.** Regarding markets, **news flow from the US will likely be of greatest significance in the short haul**. While efforts in the US to find a lasting solution to the automatic spending cut slated to take effect on March 1, 2013 -- following a 2-month deferral as of the new year -- will be high on the agenda until the end of the month, opposing views within the FOMC as regards the FED's open-ended asset purchases will also be keenly eyed.

As for the Turkish economy, we see no reason to alter our overall view of the year 2013, as fine-tuning in policy implementations will likely suffice in what seems to be essentially a year of safeguarding the gains. **One key source of risk is for growth rate to fall substantially short of potential growth rate, as in 2012**: such a development would be greeted with greater tolerance by the CBT -- intent to protect the improvement in external balances -- though a similar approach is not to be expected from the political administration. Such a situation would prompt limitations to the flexibility enjoyed by the CBT in terms of shifting its focus to different targets when necessary -- the predominant source of its effectiveness -- in the framework of its multi-instrument, multi-target monetary policy implementation. As we mentioned earlier, **the CBT**, which bases monetary policy communication on three intermediate variables (inflation expectations, loan growth and real exchange rate), has diverted its **focus recently to more imminent risks such as acceleration in loan growth and appreciation pressure on the TRL**, **given a lack of threats from inflation expectations to medium-term inflation outlook.**

From a short-term perspective, while 4Q12 growth data point to contraction in all key markets including the US, PMI indices -- a key leading indicator -- suggest global recovery will gain traction, bolstering hopes for the future. On the other hand, **growth in Turkey has remained lacklustre in the last quarter -- confounding expectations -- and leading indicators for January do not quite support hopes** of a recovery. Yet, this does not seem to affect growth perceptions for 2013, as the survey median remains unchanged at 4.2%. Moreover,

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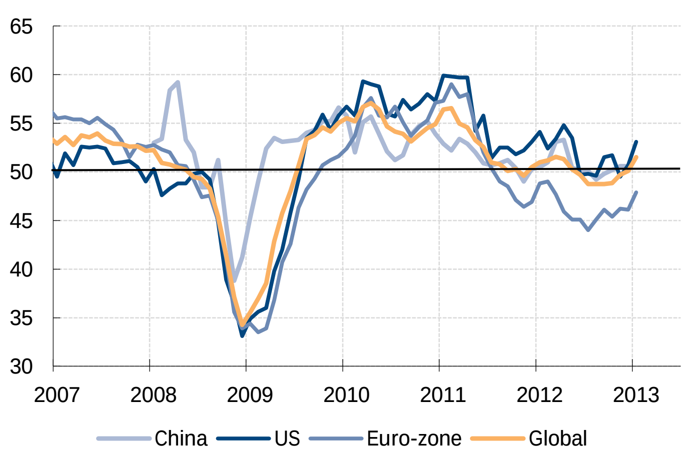
although inflation has topped 7% in January with tax adjustments, deterioration in inflation expectations should be limited as long as volatility remains subdued in exchange rates and commodity prices.

As for financial markets, our view expressed in our previous monthly report that the stock exchange index was in overbought territory was validated by the ensuing correction. In our view, selling pressure will persist for some time, subsequently leading to more of a range-bound bias. Regarding interest rates, on the other hand, the upward trend should continue, to be felt more on the long end of the curve. As for FX rates, given the CBT's well-known stance and the framework drawn for real exchange rates, we continue to expect the TRL/currency basket not to fall below 2.05 and to fluctuate within a band of 2.05 - 2.15 through the course of 2013.

Global PMI gains traction

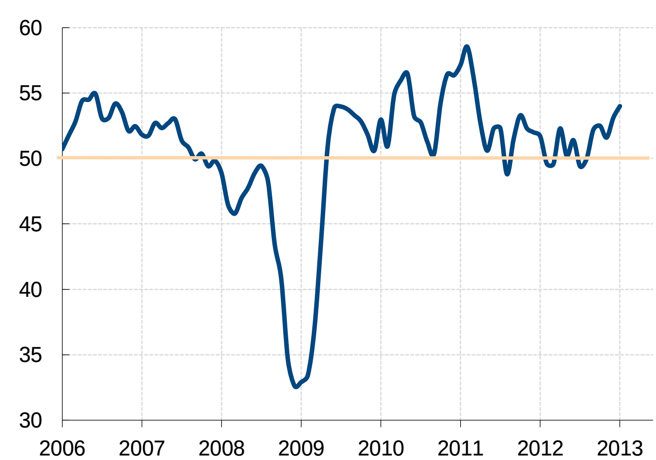
Global Manufacturing PMI Index rose to 51.5 in January, its highest since Mar'12, and up from 50.1 in December. The headline index has been trailing the 50.0 level that separates expansion from contraction during the second half of 2012. Among major industrial regions, rates of expansion were above the global average only in the US (55.8) and China (52.3). Growth was again below average in the Eurozone (47.9) and Japan (47.7), but both indices improved sharply compared to the previous month. On the other hand, Global Services PMI Index retreated slightly to 53.6 in January, while remaining in expansionary territory by a wide margin.

Exhibit 1: Global PMI



Source: Markit, Burgan Securities

Exhibit 2: Turkish PMI



Source: Markit, Burgan Securities

Revival in activity signalled by leading indicators yet to be supported by hard data

Despite encouraging PMI and loan growth levels of the last two months, hard data on the production side have failed to support this argument so far.

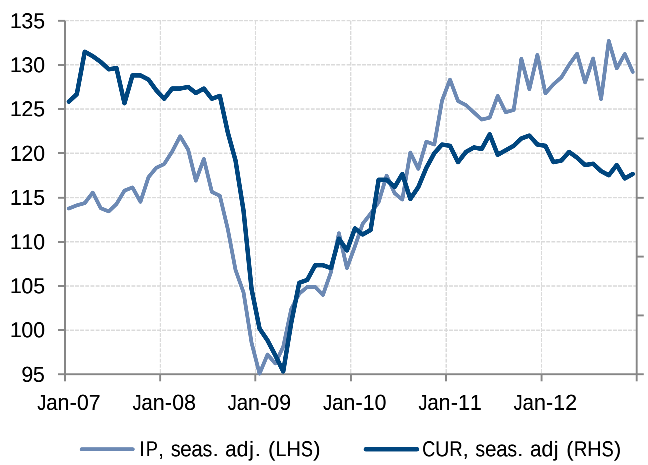
Industrial production (IP) contracted by 3.8% yoy in December, contrary to expectations for muted growth. IP adjusted for seasonality and working days also declined by 1.5% mom in December, following 1.3% mom increase in November. In other words, December IP print reversed the entire contribution of the double-digit yoy growth in November. Nevertheless, seasonally-adjusted IP still stands at 129.2, roughly 3% below the historical record of 132.7.

Similarly, capacity utilisation rate (CUR) and business confidence index suggested some softening as of January. CUR receded to 72.4% in January 2013, from 73.6% in December 2012. In seasonally-adjusted terms, this also corresponds to a weakening towards 73.1%, from 73.6% in December, marking the lowest reading since October 2010. Post seasonal adjustment, business confidence eased to 104.7, from 107.5 in December 2012. All the sub-segments of the Index, including expectations for production, employment and exports in the next 3 months, weakened in January, compared to December and November.

On the other hand, Purchasing Managers Index (PMI) has kept signalling a revival in economic activity in the last two readings. PMI rose further to 54.0 in January, from 53.1 in December, which denotes the highest reading since Mar'11.

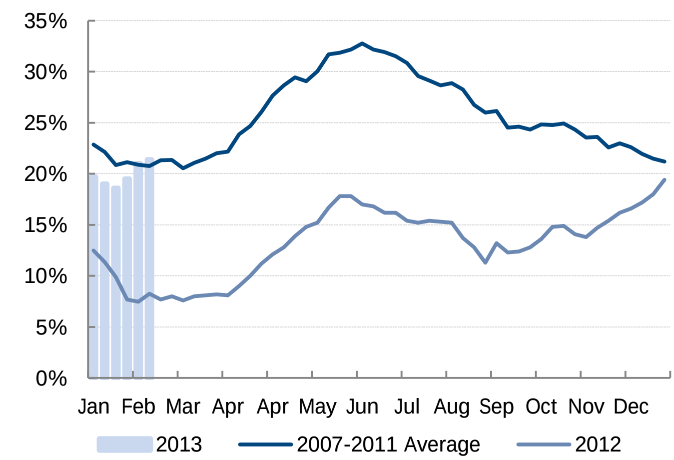
In short, economic activity was weaker than anticipated in 4Q12, driving annual average IP growth down to 2.3% yoy for 2012. Hence, we revised down our GDP growth forecast for 2012 to 2.5% from 2.9%. However, we maintained our GDP growth forecast of 4.5% for 2013, given encouraging signs regarding PMI and loan growth, stimulated by historical low interest rates.

Exhibit 3: IP & Capacity Utilisation



Source: TURKSTAT, CBT, Burgan Securities

Exhibit 4: Consumer Loans, annualised 13w MA



Source: CBT, Burgan Securities

Consumer loans at full speed…

Consumer loan rates somewhat stabilised over the last one-month period, after having eased by 250bp since the first cut in the upper band of the interest rate corridor by mid-September. However, annual consumer loan growth kept accelerating to 17.4% as of February 8, from 15.8%, as loan rates remain at the lowest level of about the past two years. Moreover, trend growth (annualised 13w MA) indicates that consumer loan growth has increased further to around 21%, even slightly exceeding the average for the corresponding period through 2007-2011.

Unemployment rate, on the other hand, has been on the rise over the last couple of months. Seasonally-adjusted UR has gradually risen to 9.5% in November, i.e. October-November-December period, up from 9.3% in October, after having lingered at historical lows of around 9% in 1H12. Seasonally-adjusted employment has still increased by 0.5% mom in the November period.

Downward trend in C/A deficit continues; revisions seem to back the trend

Rebalancing proved much stronger than expected throughout 2012, as economic growth trailed initial forecasts and exports were relatively strong, driven by market diversification and gold exports. The improvement is quite evident, even after adjusting the CAD for gold and energy.

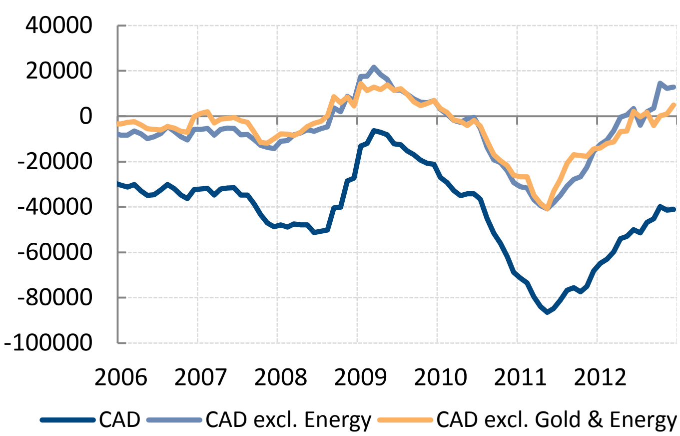
C/A deficit shrank further by 30% yoy to US$4.7bn in December as imports continued to shrink in annual terms. Imports were down by 3.7% yoy to US$19.8bn in December, much lower than market consensus of US$21.8bn. Even excluding energy and gold, imports kept contracting by 6% yoy, confirming weak data on the production side.

Exports rose by 1.4% yoy to US$12.6bn, while ex-gold exports dropped 1% yoy in December.

Gold exports have started to lose steam over the last two months. A total of US$570mn in gold exports was recorded in December, still higher than the US$245mn in Dec'11, bringing cumulative exports up to US$13.3bn in 2012. This corresponds to 8.7% of Turkey's aggregate exports within 2012. After deducting the imports, net gold exports amounted to US$5.7bn in 2012.

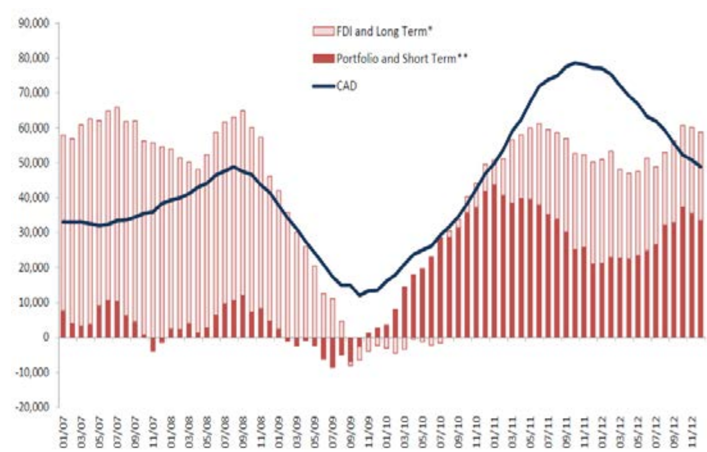
Overall in 2012, exports were up 13% yoy (only +4% yoy after adjusting for gold) to US$152.6bn, while imports fell by 2% yoy to US$236.5bn, leading to a US$84bn foreign trade deficit.

Exhibit 5: Current Account Balance



Source: CBT, Burgan Securities

Exhibit 6: Financing of CAD, 12m rolling, US$ mn



Source: CBT

C/A deficit receded to US$48.9bn as of YE12 from US$77.2bn in 2011. Based on our 2.5% GDP growth forecast, this corresponds to 6.2% of the GDP for 2012 vs. 9.9% as of 2011. Even after excluding gold and energy, C/A deficit has still improved to 0.3% of the GDP in 2012, from 3.2% of the GDP in 2011.

However, C/A deficit is likely to be revised down by US$2.2bn for 2012, after the methodology change for tourism statistics. Turkish Statistical Institute (TURKSTAT) revised tourism revenues and expenditures data last week, in accordance with changes in methodology adopted by Eurostat and World Tourism Organisation. The revisions stem from inclusion of international transportation expenditures, marina service expenditures and GSM roaming expenditures in tourism data. Accordingly, net tourism revenues were revised up by US$5.4bn for 2012, corresponding to 0.7% of the GDP. Similarly, net tourism revenues were raised by 0.1-0.6% of the GDP for 2003-2011.

Some of the items to be incorporated into tourism revenues are already included in BoP accounts by the CBT; hence, a downward revision to the C/A deficit is likely to be less. Accordingly, 2012 C/A deficit is likely to be revised down by US$2.2bn, corresponding to 0.3% of GDP. Based on our calculations, this brings C/A deficit-to-GDP ratio down to 5.9% for 2012.

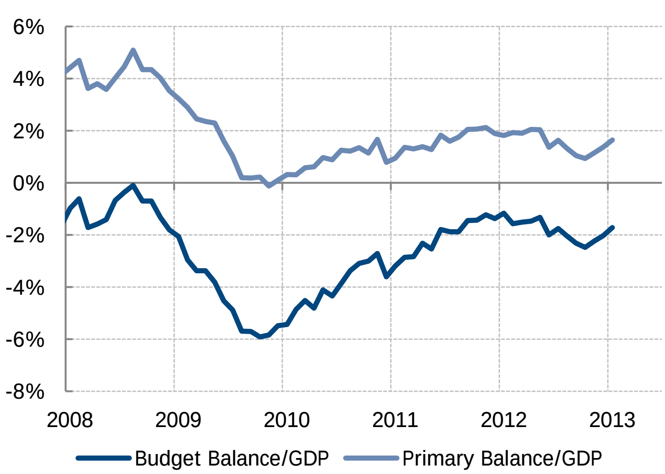
As for January, based on data released by Turkish Exporters Assembly (TIM), which exclude gold, exports rose 5.6% yoy to US$11bn. Given the declining contribution of gold exports, we estimate official exports at US$11.5bn, up 11% yoy. Regarding imports, our forecast is US$18.5bn, up 6% yoy, for January. Note that VAT on imports is up 17% yoy, though this data has recently resulted in an overestimation of official import data. Hence, 12m rolling foreign trade deficit may still recede slightly in January.

Fiscal balance improves in January, thanks to privatisation receipts

Central government budget posted better results in January compared to the same month last year. Budget surplus advanced to TRL5.9bn in Jan'13, from TRL1.7bn in Jan'12, and primary surplus rose to TRL11.2bn, up from TRL7.1bn in Jan'12.

This implies a further improvement in the budget deficit-to-GDP ratio to 1.7% as of Jan'13, from 2% by YE12. Similarly, primary surplus-to-GDP ratio rose to 1.6% in Jan'13, from 1.4% in Dec'12. Note that the government targets a central government budget deficit-to-GDP ratio of 2.2% and a primary surplus-to-GDP ratio of 1.2% for YE13.

Exhibit 7: Central Government Budget



Source: MoF, Burgan Securities

Exhibit 8: Central Government Budget

	Jan'13 TRL bn	Annual Change	Jan'13 / 2013 Target	Jan'12 / 2012
Budget Expenditures	**30,933**	**17%**	**8%**	**7%**
Primary Expenditures	25,710	23%	7%	7%
o/w Personnel	9,886	18%	10%	10%
o/w Current Exp.	1,114	29%	3%	3%
o/w Transfers	11,206	22%	7%	7%
o/w Investments	312	-40%	1%	2%
Interest Expenditures	5,222	-3%	10%	11%
Budget Revenues	**36,872**	**31%**	**10%**	**8%**
Tax Revenues	28,446	21%	9%	8%
o/w Income Tax	6,101	12%	10%	10%
o/w Corporate Tax	258	-44%	1%	2%
o/w VAT	4,418	12%	12%	13%
o/w SCT	7,289	55%	9%	7%
o/w VAT on Imports	3,605	13%	6%	6%
Budget Balance	**5,939**	**241%**	**-17%**	**-6%**
Primary Balance	**11,162**	**57%**	**59%**	**36%**

Source: MoF, Burgan Securities

If we were to deduct privatisation receipts and interest income, the performance is comparable to the year-ago month. Central government revenues rose by 31% yoy in Jan'13, driven by TRL4.2bn privatisation receipts from Halkbank SPO, TRL950mn interest income, and tax hikes introduced as of Oct'12. Tax revenues were up by 21% yoy.

We keep our forecast for the central government budget deficit-to-GDP at 2.2% for 2013, which indicates some deterioration compared to the 1.7% as of January. We think expected receipts from the ambitious privatisation efforts will be partly offset by a lower contribution from the CBT's profits (TRL5.7bn in 2012) this year. The government projects TRL9.5bn (0.6% of GDP) in privatisation revenues for 2013. According to the Privatisation Administration, TRL13.1bn worth of privatisation implementations are pending approval as of February, though part of those might be cancelled.

Inflation accelerates on the back of food and tobacco prices in January

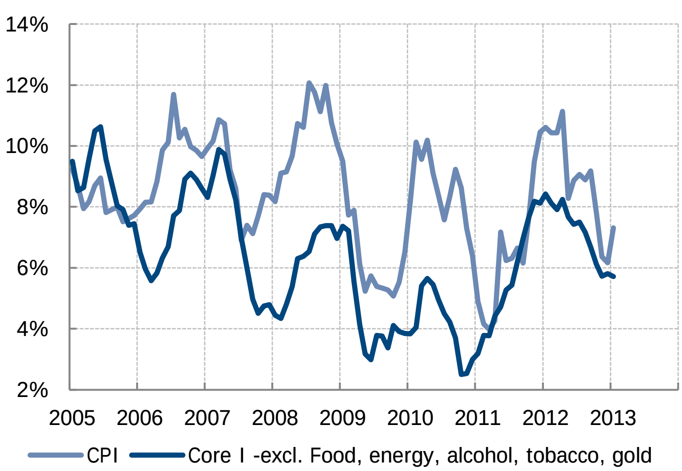
Consumer prices rose by 1.65% mom in January, exceeding even our above-market forecast of 1.35%. Thus, annual inflation jumped to 7.3% in January, from 6.2% by YE12.

The acceleration in inflation stemmed from price adjustments to tobacco, along with a surge in food prices. Tobacco prices increased by 15% mom, following the tax hike as of January, contributing 0.7pp to the headline inflation.

Food prices, particularly unprocessed food, soared by 4% mom in January, driving annual food inflation to 6.9% in Jan'13 from 3.9% in Dec'12. Hence, the favourable trend in food inflation, which backed the disinflation trend throughout the year 2012, has shifted course as of January.

The downward trend in core inflation seems intact as of January. Core inflation I (excluding food, energy, alcohol, tobacco and gold) decelerated slightly to 5.7% from 5.8% in December. The deceleration has actually proved short of our expectations, mostly due to a somewhat milder-than-forecast seasonal drop in clothing prices. Despite the CBT's guidance of below 5% core inflation for YE13, we remain cautious on the back of an expected revival in domestic demand in 2013.

Exhibit 9: Annual Inflation



Source: TURKSTAT, Burgan Securities

Exhibit 10: Contributions to Headline Inflation

	Jan'13		Dec'11	
	Annual Change	Contribution to Headline CPI	Annual Change	Contribution to Headline CPI
CPI	7.31%		10.45%	
Core I	5.72%	3.2	8.12%	4.2
Food	6.85%	1.7	12.21%	3.3
Alcohol & Tobac.	15.35%	0.8	18.50%	1.1
Energy	11.90%	1.7	10.36%	1.5
Gold	-3.00%	0.0	46.60%	0.3

Source: TURKSTAT, Burgan Securities

Episode II: Cuts in interest rate corridor; hikes in RRRs

The Monetary Policy Committee (MPC) continued with the same measures in February, aiming to rein in the appreciation pressure on the TRL and acceleration in loan growth. Similar to the previous month, the MPC cut the lower and upper bands of the interest rate corridor by 25bp each, while nudging up slightly the reserve requirement ratios (RRRs) on both TRL and FX liabilities.

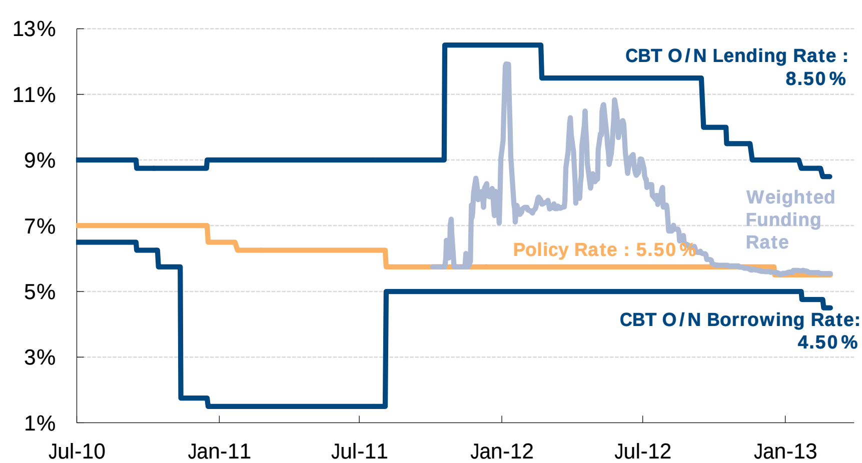
The MPC cut the lower and upper bands of the interest rate corridor by 25bp each to 4.50% and 8.50%, respectively, while leaving the policy rate unchanged at 5.5%. Note that the TRL has been trading at around 2.06 against the currency basket recently, hinting at another real effective exchange rate (REER) reading slightly above the 120 threshold in February.

On the back of the recent acceleration in loan growth, the CBT again raised the RRRs on TRL liabilities by 20bp to 11% (weighted average) and on FX liabilities by 40bp to 11.5% (weighted average). Given the Reserve Option Mechanism (ROM), this will lead to TRL0.3bn and US$1.4bn withdrawal from TRL and FX liquidity, respectively.

The only visible change in the accompanying MPC statement pertains to inflation outlook: the CBT expects headline inflation to keep decelerating, yet no longer envisages core inflation keeping its downward trend, rather to "follow a mild course".

In the absence of any signals for the upcoming meeting, the decision will continue to depend on data, namely the REER and loan growth trend. The CBT is likely to repeat its actions in the event that the REER deviates from its pre-defined level and loan growth overshoots the 15% target.

Exhibit 11: Key Interest Rates



Source: CBT, Burgan Securities

Exhibit 12: Burgan Securities Macroeconomic Forecasts

	2008	2009	2010	2011	2012F	2013F
GDP (TRL bn)	950.5	952.6	1098.8	1298.1	1426.3	1595.1
GDP (US$ bn)	732.0	615.8	733.2	776.1	796.0	874.7
GDP Growth (yoy)	0.7%	-4.8%	9.2%	8.5%	2.5%	4.5%
TRL/US$ (level, eop)	1.5218	1.4873	1.5376	1.8889	1.7776	1.8520
TRL/US$ (yoy change, eop)	31.3%	-2.3%	3.4%	22.8%	-5.9%	4.2%
TRL/US$ (level, avg)	1.2985	1.5469	1.4986	1.6725	1.7918	1.8235
TRL/US$ (yoy change, avg)	-0.1%	19.1%	-3.1%	11.6%	7.1%	1.8%
CPI Inflation (eop)	10.1%	6.5%	6.4%	10.4%	6.2%	6.5%
CPI Inflation (avg)	10.4%	6.3%	8.6%	6.5%	8.9%	6.6%
PPI Inflation (eop)	8.1%	5.9%	8.9%	13.3%	2.5%	6.0%
PPI Inflation (avg)	12.7%	1.2%	8.5%	11.1%	6.1%	4.8%
Exports (US$ bn)	132.0	102.1	113.9	135.0	152.6	163.0
Imports (US$ bn)	202.0	140.9	185.5	240.8	236.5	257.0
Trade Balance (US$ bn)	-69.9	-38.8	-71.6	-105.9	-83.9	-94.0
C/A Balance (US$ bn)	-41.5	-13.4	-46.6	-77.2	-48.9	-62.0
C/A Balance (as % of GDP)	-5.7%	-2.2%	-6.4%	-9.9%	-6.2%	-7.0%
CG Budget Balance (% of GDP)	-1.8%	-5.5%	-3.6%	-1.3%	-2.0%	-2.2%
PS Primary Surplus-Programme defined (% of GDP)	1.6%	-1.0%	0.1%	1.7%	0.3%	0.2%
Gross Debt of Public S. - EU defined (% of GDP)	40.0%	46.1%	42.4%	39.4%	36.5%	36.0%
CBT Funding Rate* (eop)	15.00%	6.50%	6.50%	9.04%	5.55%	6.25%
Yield on Benchmark Bond (eop)	16.47%	9.06%	7.08%	11.04%	6.18%	7.25%

**Policy Rate (1w Repo) till Oct'11; Weighted Funding Rate after Oct'11*
Source: TURKSTAT, CBT, Turkish Treasury, Burgan Securities

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