VAKIFBANK TURKISH ECONOMY WEEKLY

How will Turkish Economy Perform in 2011?

No 5 : Financial Markets - Interest Rate

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No: 6

Vakıfbank Economic Research

Having analyzed economic growth, inflation, current account balance and unemployment rate, this week we are examining benchmark bond rate trend in 2011

Previous Weeks

Real GDP Growth Rate

Inflation and Monetary Policy

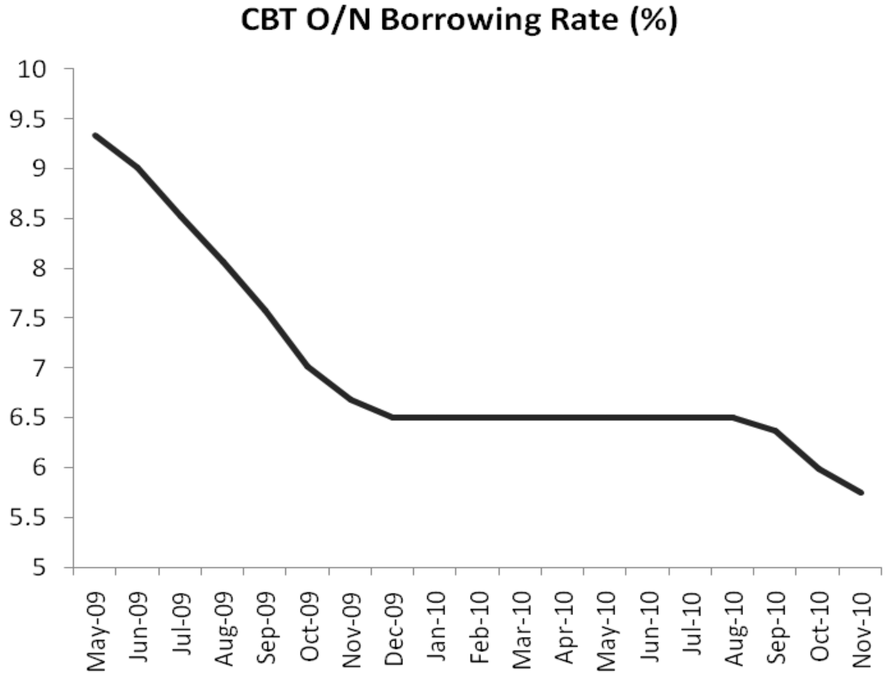
Current Account Balance

Unemployment Rate

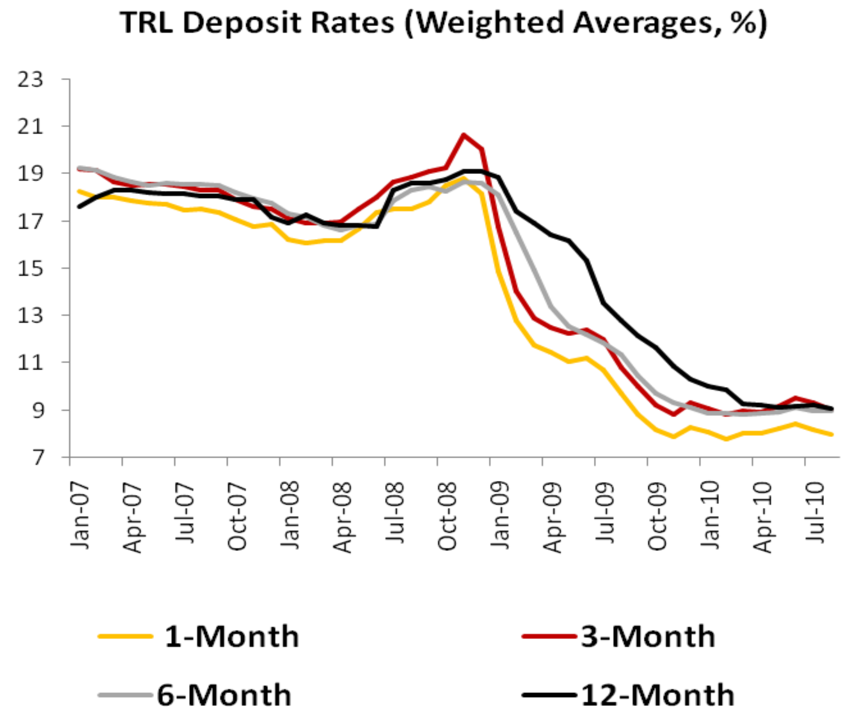
This Week

Financial Markets: Interest Rate

We expect an increase in interest rates by the end of Q2 2011 due to inflationary pressures



Source:Bloomberg



Source: CBT

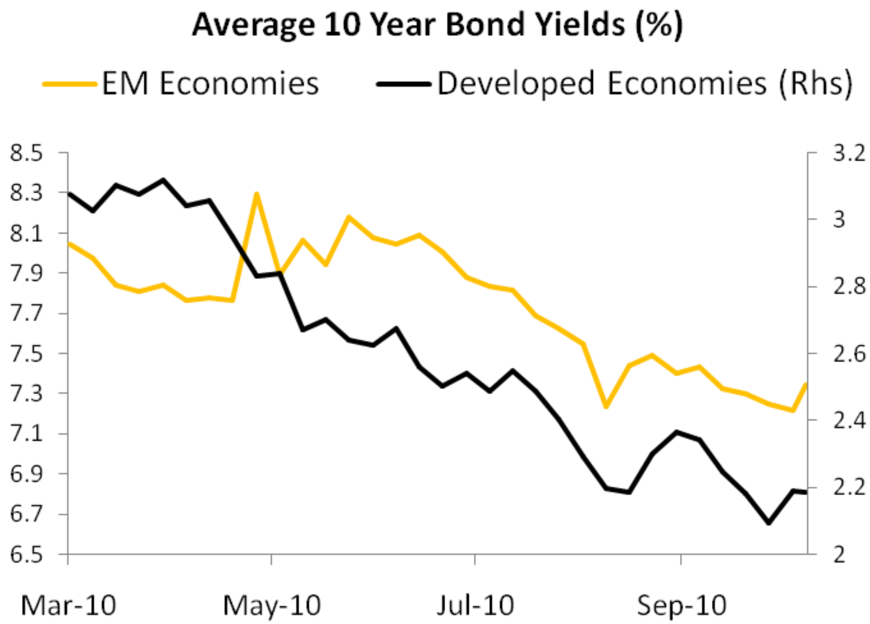
As a result of the declining risk premium and falling prices, interest rates in Turkey has a downtrend. We envisage this trend to continue until the rate hikes start in the end of Q2 2011 due to the inflationary pressures. But the possibility of core inflation to stay moderate in 2011, might enable Central Bank to keep interest rates at current levels for a longer time.

Banking sector asset allocations is expected to support the downward trend in Treasury bond yields in 2011

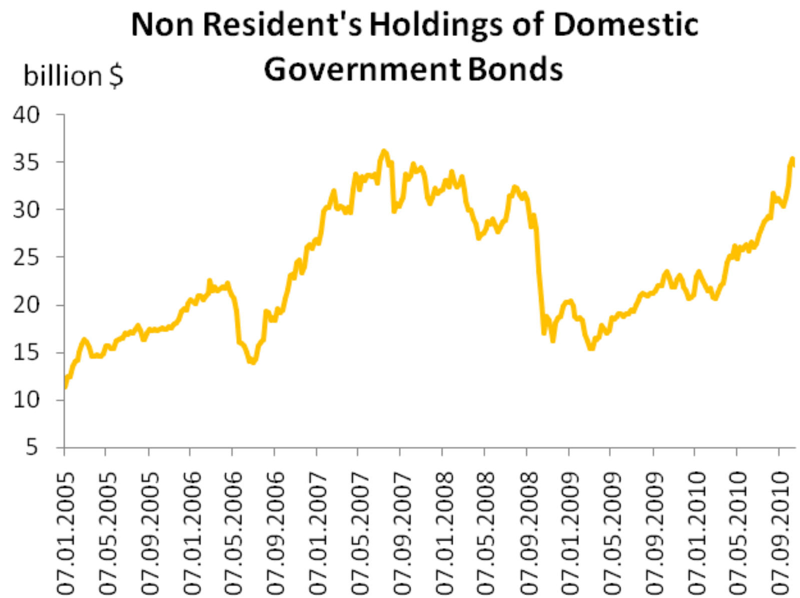
Turkish Banking Sector Projections		
(y/y, %)	***2010***	***2011***
Total Assets	18.7	19.9
Credits	27.3	26.1
Securities Portfolio	11.0	11.9
Source: VakifBank		

- *We are expecting the securities portfolio of the Turkish banking not to shrink because of the deterioration in the interest income as a result of the fall in Treasury bond yields.*
- *The increasing foreign demand for treasuries and the remarks of the Central Bank to keep policy rates stable until Q2 2011, seem to encourage banks to keep their securities holdings high.*
- *Credit growth of the banking sector is expected to proceed in 2011 as a result of the increasing domestic demand. But, the increasing competition in credit markets might limit the contraction of total securities portfolio.*
- *Also the relatively slow growth performance of Turkish economy in 2011 due to the negative base effect, might limit credit growth of the sector. This might give another reason for Turkish banks to increase demand for treasuries.*
- *Therefore, we don't have much reason to expect the market interest rates to fall because of bond demand in 2011, unless a sudden capital outflow is experienced.*

FED's QE2 is keeping global bond yields at low levels, but the possible increase in inflationary pressures might invert the current picture



Source: Bloomberg
Developed Economies: US, Japan, Germany, UK
EM: Brazil, South Africa, Turkey, Hungary, Poland.



Source: CBT

- *The negative outlook of the US economy has led the way to the second stage of FED's quantitative easing, implying an extended period of low interest rates in the US and the global economy.*
- *QE2 is expected to enhance the demand for EM assets and Turkish bonds for the time being. But, as soon as the inflationary effects of the QE2 arise, capital outflows might take the stage, increasing the bond yields.*

Sudden stops in the capital inflows would increase Treasury yields

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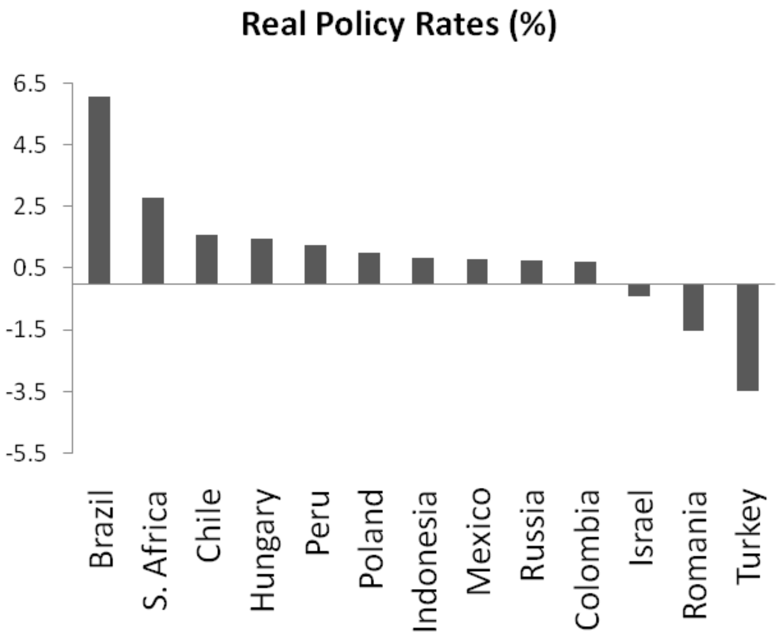
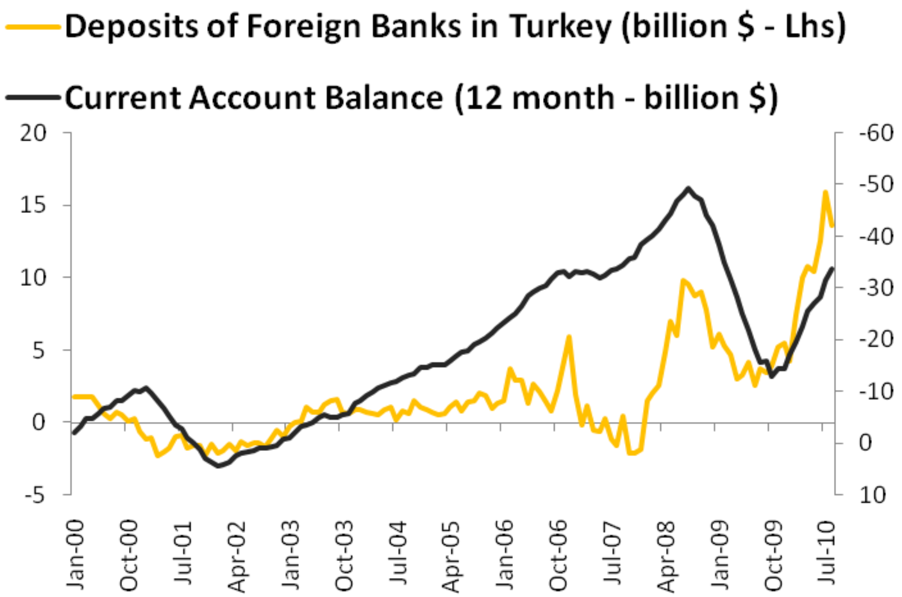


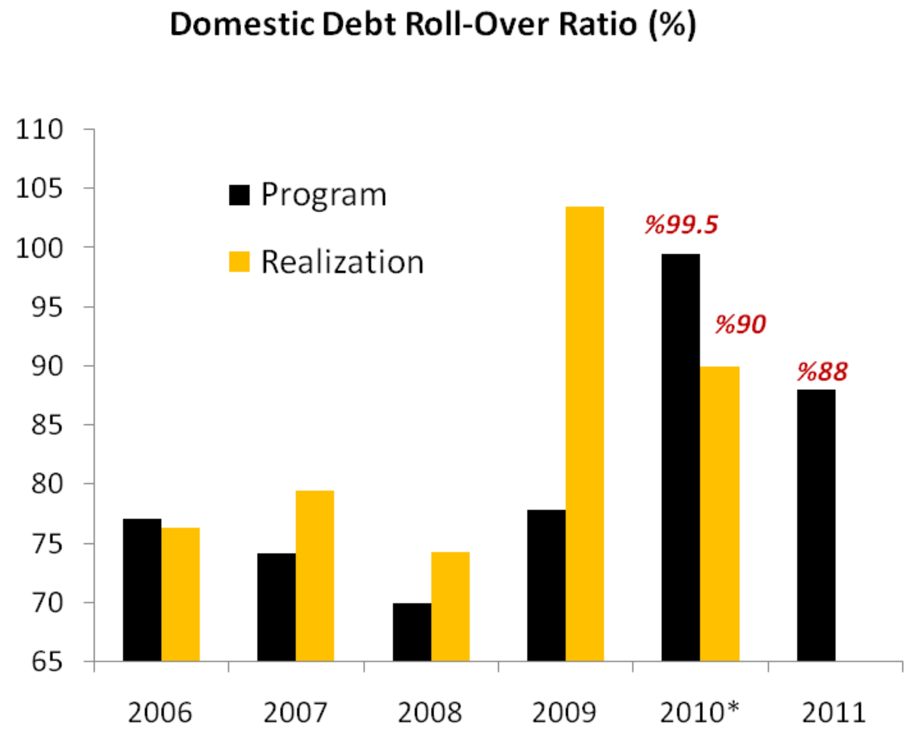
Source: Bloomberg



Source: CBT

- *Despite the negative real policy rate and the real market rates close to zero in Turkey, capital inflows has become an important item in financing the increasing current account deficit.*
- *This makes Turkish economy and financial markets vulnerable to a sudden deterioration in the global markets.*
- *Such a panic in the markets would inevitably trigger a rapid increase in Treasury bond yields.*

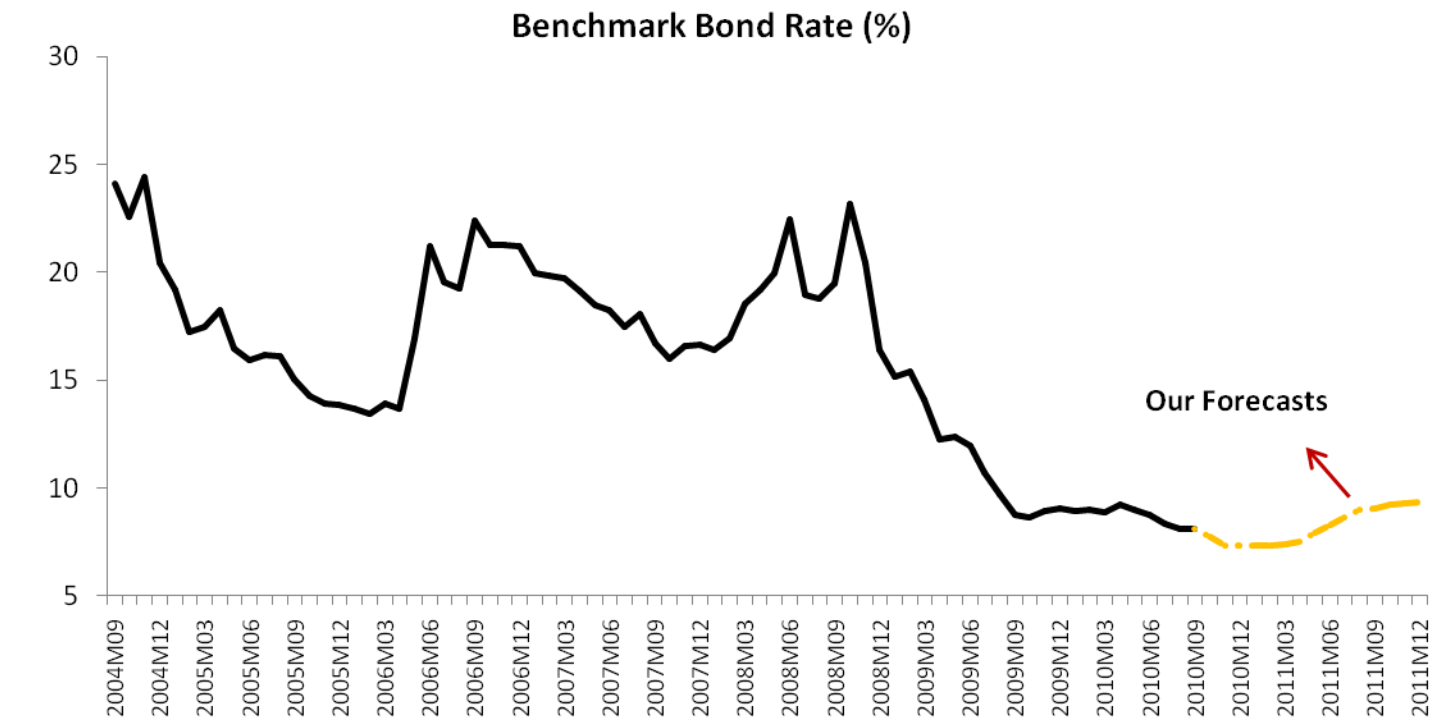
Easing fiscal dominance might prevent increases in Treasury yields



*2010 year-end estimate
Source: Undersecretary of Treasury

- *Turkish Treasury forecasts an annual domestic debt roll-over ratio of 88% in 2011, after a 90% rate in 2010 which was revised from an initial forecast of 99.5% thanks to the improving fiscal discipline.*
- *The 88% domestic debt ratio is quite suitable for central bank's further tightening of liquidity.*
- *Also the debt/GDP ratio prevision of government in the Medium Term Program which is set at 40% implies that the Treasury won't have high financing needs in 2011.*
- *This means that public finance won't create upward pressures in interest rates in 2011.*

Econometric Analysis: Our benchmark bond rate forecast for the end of 2011 is 9.35%



Sources: Bloomberg, Vakıfbank

Our econometric model results show that benchmark bond rate may remain at low levels until Q2 2011. After Q1 2011, the upward movement in inflation especially driven by commodity prices may force CBRT to hike benchmark repo rate at the end of Q2 2011. Moreover, US 10 year government bond rate is expected to rise during 2011. Under these considerations, benchmark bond rate may begin to rise again towards the end of Q2 2011. Benchmark bond rate may increase until Q4 2011 but a slowdown should be expected since then.

Scenario Analysis: Under the scenarios prepared within the framework of our studies on Turkish economy in 2011, the benchmark bond rate is expected to change between 7.80% and 11.1%.

	CPI (yoy,%)	USD/TRY	CBT Benchmark Repo Rate	US 10 Year Government Bond Rate (%)	Benchmark Bond Rate (%)
Base Scenario	7.15%	1.5	8.00%	3.30%*	9.35%
Scenario-1	9.40%	1.55	9.00%	3.90%	11.10%
Scenario-2	5.50%	1.4	7.00%	2.25%	7.30%
Source: VakıfBank					

*Bloomberg Forecast

Score matrix: Total effects of macroeconomic and financial indicators on benchmark bond rate

Score Matrix			
	Positive	Negative	Neutral
GDP			✓
Inflation		✓	
Current Account Deficit		✓	
Budget Deficit	✓		
Debt Stock	✓		
CBT Benchmark Repo Rate			✓
USD/TRY			✓
Total effect	2	2	3

Public finance, which is one of the major sources of vulnerability in the past, is expected to have a positive effect on market rates in 2011. On the other hand, general elections in 2011 and upward movement in commodity prices could create inflationary pressures in 2011. Increase in the weight of short-term capital inflows in financing of the current account deficit, is a major risk for the sudden capital outflows. Both inflationary pressure and risk on sudden capital outflows may support upward pressure in market rates. The effects of GDP, CBT benchmark repo rate and USD/TRY on benchmark bond rate are not expected to have a specific direction.

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