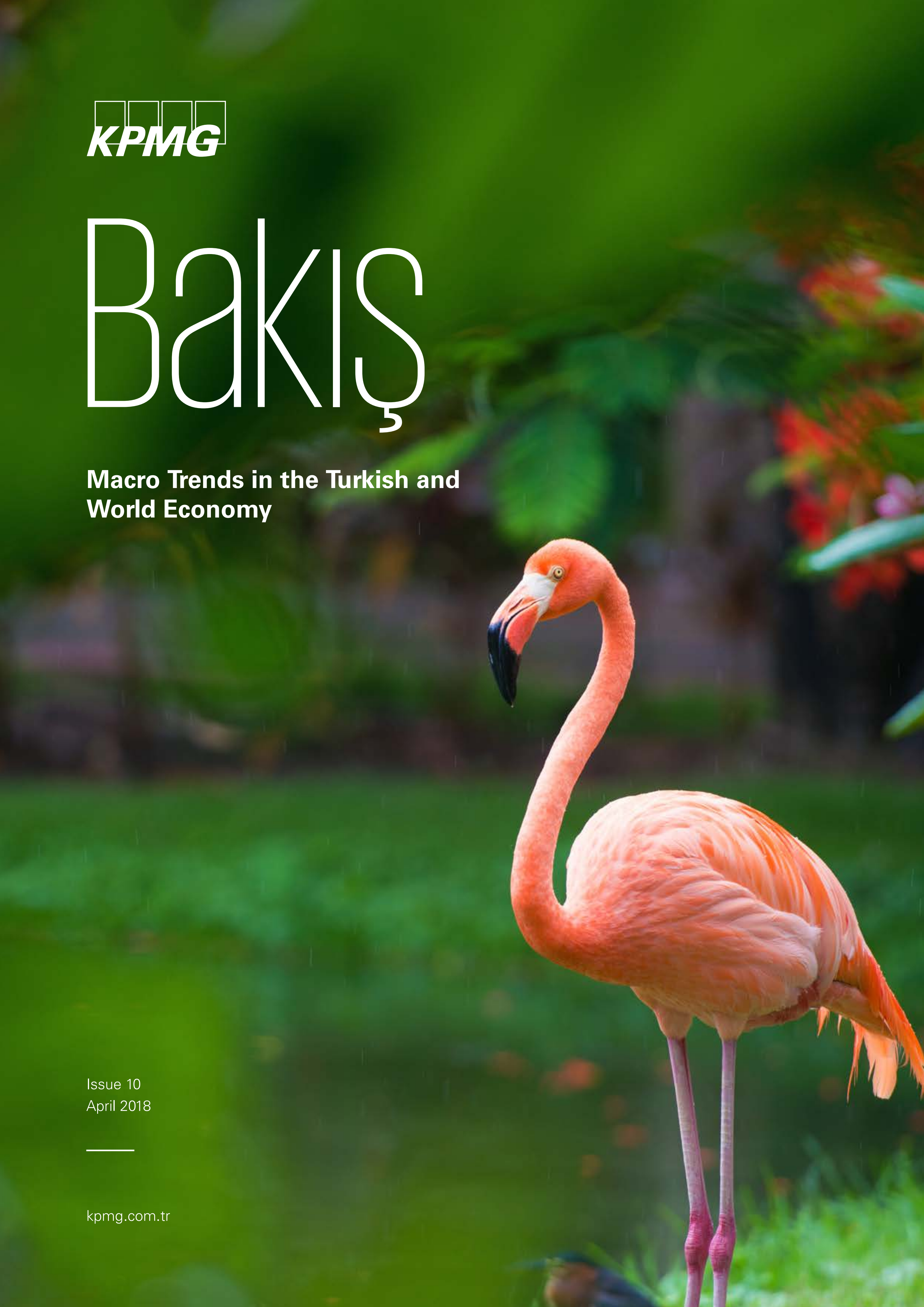

Bakış

Macro Trends in the Turkish and World Economy

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General outlook

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We indicated in our previous 'Bakış' issued in January that the world economy concluded 2017 as a year with a climate of strengthened hopes for the future. Furthermore, we underlined that the expectations for 2018 were on a positive trend both in Turkey and globally, however, we also pointed out a potential pessimistic scenario with the following lines:

"There is a possibility of political and diplomatic developments turning things upside down in the world economy in 2018."

As we leave behind the first quarter of 2018, the negative effect of the ever-threatening trade wars between the USA and China, the world's two giant economies, have started to become apparent. Despite the healthy data coming from the real economies of several countries, the global trade war threat ignited with the USA imposing a customs duty on the importation of steel and aluminum is causing the financial markets to suffer from increased fluctuations.

Nevertheless, in an environment where all the market players and investors have been closely monitoring the tension between the USA and China, the first data for 2018 indicates that world trade has still been maintaining its expanding trend. Export figures throughout the world increased by 17.5%, while import figures rose by 21.7%.

At a meeting in March, the FED increased political interest rates by 25 basis points, strengthening the anticipation that this year we may be witnessing three interest hikes from the FED. Expectations of an interest hike for 2019 and 2020 were also raised from two to three. This is seen as an indication that Jerome Powell, the new Chairman of the Federal Reserve will seek more 'hawkish' policies in the long term.

The Eurozone, which has been maintaining its moderate growth, achieved a growth rate of 2.3% in 2017. The core CPI in EU countries gradually rose from 0.9% to 1.1% in terms of the annual inflation rate. The fact that the first quarter saw the establishment of a great coalition in Germany, which is the largest economy of the Old Continent, was a reassuring step for the markets.

Moreover, an agreement between the EU and the UK for the terms of the Brexit process, despite the remaining problematic issues with the UK's withdrawal, has been noted as an important development.

As for emerging economies, including the Turkish economy, they continued to give positive signals also in the first quarter of 2018, despite the fluctuations in the financial markets. Turkey, in particular, achieved significant success during this period by becoming the leader of the G20 in terms of growth with a total growth rate of 7.4% in 2017. When we take a look at early 2018 we see that the growth rate of the Turkish economy is still trending above its potential, despite a limited loss of momentum.

However, Turkey is also one of those countries being affected by the weakened risk appetite that we have begun to see in the global markets following their optimistic start to 2018 as a result of protective trade trends, geopolitical risks and constrictions in financial conditions. The Turkish financial markets become subject to selling pressure in such an environment. The high levels seen in the current deficit and challenges disguised as inflation apply an upside pressure on exchange rates and interests. The decrease in the Turkish Lira's value against the USD reached 7% just in the first week of April.

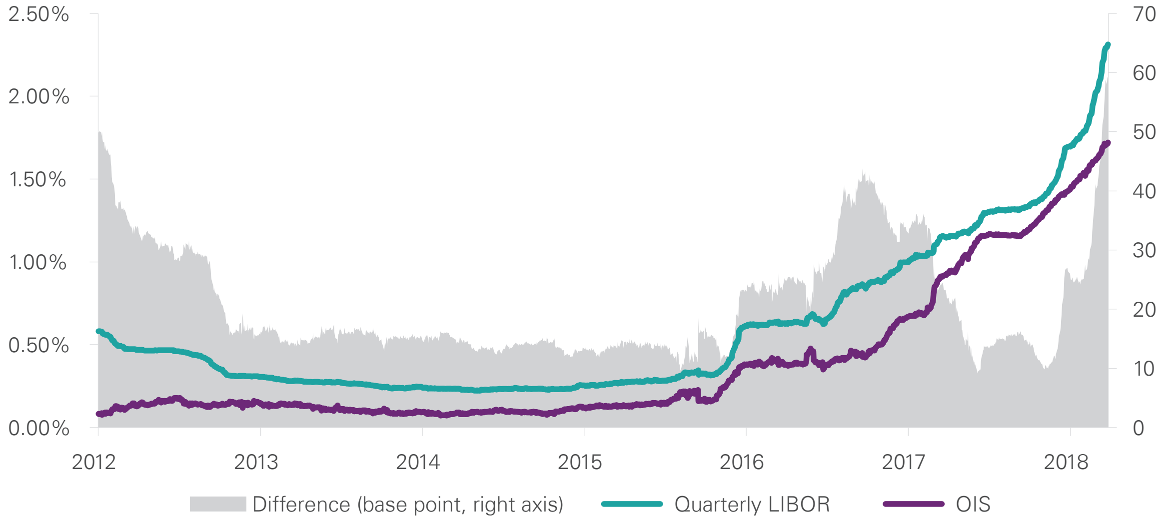
Consequently, the increased fluctuation seen in the financial markets in the first quarter of 2018 may have damaged the reliability of economic units a little, but we cannot talk of a very negative effect on economic fundamentals just yet. So far there hasn't been a significant deterioration in the global trade data. Hence why actors in the economy are maintaining their deliberate optimism for the upcoming period.

I hope you enjoy reading the report,

Overview of the global economy

- The world economy, which left a strong legacy behind in 2017, had a tough start in the first quarter of 2018. Despite the healthy data coming from the real economies of several countries, the negative developments in the global trade, such as the USA imposing a customs duty on the importation of steel and aluminum, has caused the financial markets to suffer from increased fluctuations.
- Anticipations of the FED speeding up interest hikes caused dollar-funding costs to reach their highest level in years. The quarterly USD LIBOR interest rates which were 1.69% at the end of the year increased to 2.31% at the end of March. Overnight Indexed Swap (OIS) rates, on the other hand, increased from 1.43% to 1.72% in the same period.
- As the advanced economies continue to give positive growth signals, details regarding inflation dynamics have also confirmed the continuation of a gradual improvement. However, tax reductions and incentives in the USA in particular have reinforced the expectation of inflation and thus the anticipations of the FED speeding up its interest hikes.

Borrowing rates in USD



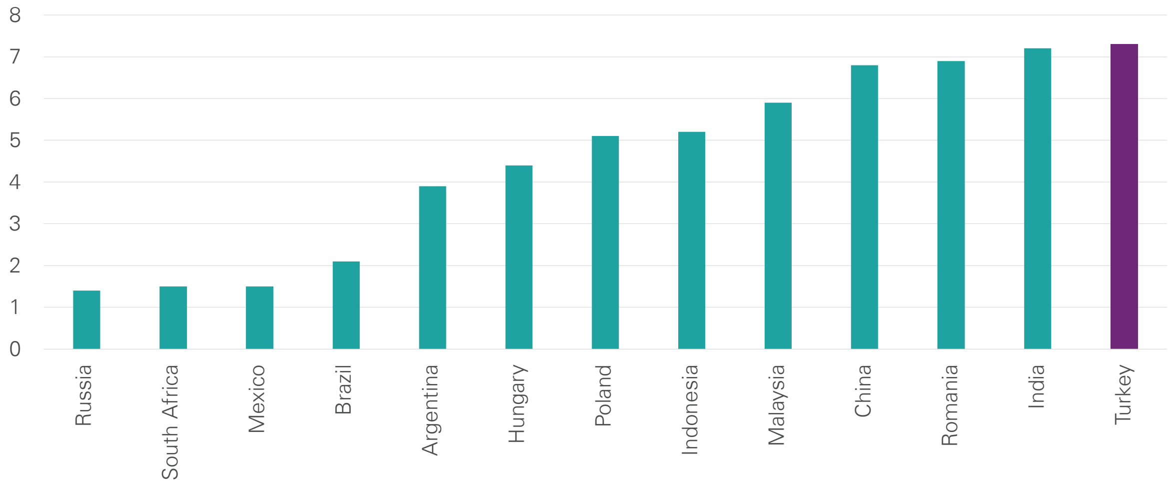
USD Index

Source: Bloomberg, investing.com

Overview of the Turkish economy

- Although global and local uncertainties are high, the Turkish economy concluded 2017 with a robust growth performance. Turkey secured its place as the fastest growing economy among some leading countries with its growth rate of 74% achieved throughout 2017. Despite a limited loss of momentum seen in the growth rates in early 2018, the Turkish economy has still been trending above its potential.
- While the current deficit continues to increase as a result of vibrant economic activities, the challenges occurring on the part of inflation due to fluctuations in exchange rates and food prices continue to be a noteworthy issue. The current deficit-national income ratio in 2017 was the highest of four years at 5.5%. In the 12-month total the current deficit increased to over 50 billion USD. Added to this, as of March inflation has yet to fall to single-digit levels.
- In addition to the vulnerabilities in the global risk appetite, anxieties seen at home concerning the inflation and current deficit are opening the way for sales transactions in the financial markets. At a time when a floating trend is dominant in equity markets, significant hikes are being seen in exchange rates and interests.
- Resource costs and loan interests continue to increase in the banking industry due to fluctuations in the financial markets. This results in a restrictive effect on credit growth and general economic activities in the industry. It is expected that the Central Bank of Turkey (TCMB) will preserve its current firm stance due to upside risks on the inflation outlook and that the momentum of growth in the upcoming period will depend on the structural reform performance of economic management, as well as the extent to which fiscal policy instruments are used.

2017 Q4 GDP annual growth rates (%)



Source: The Economist

Conclusion

- 2017 was a year when growth rates were supported by both domestic and foreign demands. However, in the first quarter of 2018 the domestic and foreign demand contributions decreased in the Turkish economy. Nevertheless, leading data indicates that this slowdown in growth will remain limited with private sector consumption and investment demand maintaining their strength.
- Developments in exchange rates and other cost elements may cause a limited improvement in inflation. Although the TCMB is following a wait-and-see strategy for now, it may need to take additional actions if the expected improvement in inflation is interrupted.
- 2018 started with an increased foreign trade deficit due to the raised energy bill rates and gold imports. This increase in foreign trade deficit and current deficit may decelerate in the forthcoming months of the year if the gold trade normalizes and the energy bill raise slows down.
- Although credit growth momentum decreased in the banking industry, the upside pressure on interest rates continues. For this reason, deposit interests continue to rise in the industry and loan interests maintain their high level positions despite the weakening fund demand.
- The fact that the optimism reflected in the global markets early in the year turned unfavorable and that there is a need for external financing are causing an increase in exchange rates. As a domino effect this also causes an increase in inflation and interest rates, limiting the range of motion for the monetary policy.
- Although it is seen as a positive element in terms of capital flows when the growth maintains its strength despite a little bit of a slowdown, the challenges with the current deficit and inflation are causing Turkish financial assets to become subject to a selling pressure during times of global risk aversion. Thus, it is of great importance to reduce the effects of geopolitical tensions and non-economic uncertainties and quickly carry out the structural reforms aimed at boosting the resistance of the economy so as to maintain the long-term economic stability.

Expectations for 2018

Growth

The Turkish economy, which concluded 2017 with a robust growth performance of 7.4%, is expected to lose a little bit of momentum in 2018. The contribution of foreign demand and pro-growth policies is decreasing, thus, the growth rate is anticipated to drop below 6%. It is thought that the state should offer additional support in order for the growth rate to increase again to the level of about 7%.

Inflation

The general CPI annual inflation rate, which was 11.92% at the end of 2017, is expected to see an improvement of 2 to 3 points in the upcoming period. However, the future trend of exchange rates will be the determining factor in terms of the level that we'll see by the end of 2018. Hence, inflation carries the risk of continuing to stay at double-digit levels, and is still expected to be at a level of about 9.5 by the end of 2018.

Foreign Trade

It is likely that export operations will reach a value of 175 billion USD with a growth rate of 10% as the foreign trade partnering economies display positivity despite geopolitical uncertainties. Import operations, on the other hand, may reach a value of 270 billion USD depending on commodity price trends.

Tourism

It is expected that tourism income will rapidly increase in 2018 as well, rising from about 22.5 billion USD to 27 billion USD.

Growth expectation for 2018

5.6%

2018 GDP expectation

910 billion USD

2018 foreign trade expectation

Exports 175 billion USD

Imports 270 billion USD

Markets (year average)

USD / TRY	: **4.00**
EUR / TRY	: **4.80**
EUR / USD	: **1.20**
Oil	: **70 USD**

Unemployment

11%

(year average)

Inflation

10%

(year average)

Current deficit

52

(billion USD)

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