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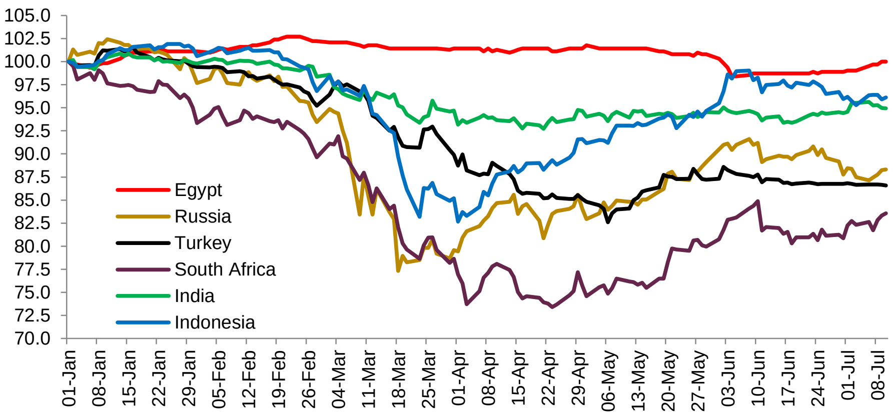
13 July 2020

Turkey's performance remains lacklustre but recovery is promising

- Structural indicators highlight the pain the COVID-19 pandemic has taken on economic output though activity readings are displaying a promising recovery. Industrial output and capacity utilisation suggest that, despite strong economic momentum in January and February this year and a Q1 GDP figure that was stronger than our expectations, the economy continues to operate below the pre-virus path. Moreover, the drag from exports, less than perfect stimulus and lira (TRY) depreciation are all taking a toll on output. Having said that, activity indicators such as PMI, mobility statistics, credit card spending and bank lending figures all suggest a promising recovery is underway. In addition, the turbulence in financial market indicators is abating with the TRY stabilising after hitting a low in May and the equity market has trended up for several weeks. On net, we see a -4.6% y/y decline in real GDP in 2020 with a rebound to +3.7% y/y in 2021.
- Policy support has been prevalent even pre-COVID-19. While governments and central banks across the world have stepped in to support the economy when the COVID-19 shock hit in March, the Turkish authorities had been doing so since 2019. However the policy response has been unorthodox. The Central Bank of Turkey (CBRT) has been aggressive in its easing cycle, bringing the real policy rate to -4% most recently. In June, the CBRT kept rates on hold, pointing to accelerating core price pressures. Though they also appear to expect a relatively robust recovery in economic activity in the second half of this year.
- Despite promising prospects, risks remain tilted to the downside. On growth, we see the risks as being tilted to the downside. With short-term external liabilities at USD168bn (north of 20% of GDP), Turkey is still vulnerable to a funding shock. Even a short-lived stop in capital flows could take a large toll on confidence, domestic activity as well as the private sector balance sheet, deepening the recession and delaying the eventual recovery. We expect the tourism sector to stay near-shut throughout Q2 and early Q3 2020. Portfolio outflows have accelerated too. These pressures have put significant stress on the CBRT's FX reserves, which fell by USD27bn between January and May.

TRY AND SELECT EM CURRENCIES VS. USD (REBASED 1 JAN 2020 = 100)



Source: Bloomberg, MUFG MENA Research

Turkey's performance remains lacklustre but recovery is promising

Structural indicators highlight the pain but activity readings are signalling a recovery

Following a sharp contraction between March and May, Turkey is beginning to recover. Industrial output and capacity utilisation suggest that, despite strong economic momentum in the first two months of this year and a Q1 GDP figure that was slightly stronger than our expectations, the economy continues to operate below the pre-virus path. Moreover, the drag from exports, less than perfect stimulus and lira (TRY) depreciation are all taking a toll on output. Having said that, activity indicators such as PMI corporate activity, mobility statistics, credit card spending and bank lending figures all suggest a promising recovery is underway. In addition, the turbulence in financial market indicators is abating with the TRY stabilising after hitting a low in May and the equity market has broadly trended up for several weeks. On net, we see a -4.6% y/y decline in real GDP in 2020 with a rebound to +3.7% y/y in 2021.

Oil price decline has been a boon but funding shock uncertainties linger on

As an energy importer, Turkey has benefitted from the oil price decline. It is also a domestic demand driven economy that is less integrated into global supply chains, which has allowed it to be relatively more resilient than its competitive peers in the face of the external demand shock. Nevertheless, Turkey remains uniquely vulnerable to a funding shock and the policy buffers that could have been relied upon to combat the recession, or the contractionary impact of capital outflows, have largely been used up.

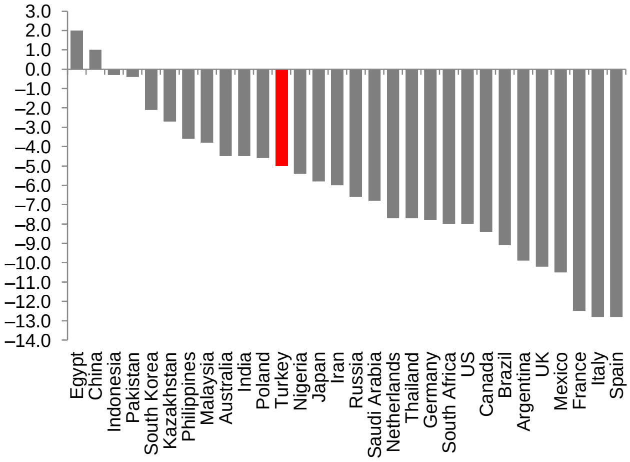
FX deposits are down but gold savings are up

The most recently published weekly banking sector data demonstrates that Turkish households increased their FX deposits for the third consecutive week, with a rise of USD0.9bn during the week ending 3 July. Since the start of this year, however, household FX savings are down by USD7.3bn and currently stand at USD100.3bn. Gold deposits, meanwhile, are up by USD11.0bn year-to-date, a much faster pace of increase compared to the USD5.9bn gain in 2019 as a whole. Corporates' FX deposits fell by USD1.8bn over the same week, but they are up by USD4.1bn this year and stand at USD76.7bn currently.

Portfolio outflows continue

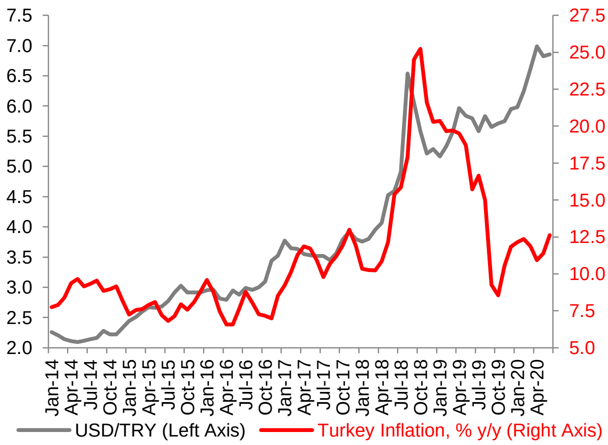
Since the start of this year, outflows have reached USD4.1bn and USD7.0bn for equities and bonds, respectively. This follows total outflows of USD1.8bn in 2018 and USD2.7bn in 2019. At around USD15bn (~2% of estimated GDP), we expect

REAL GDP (%) IN 2020: TURKEY AND SELECT COUNTRIES IN IMF'S JULY 2020 WEO UPDATE



Source: Bloomberg, CBE, MUFG MENA Research

EGP AND SELECT EM CURRENCIES AGAINST USD (REBASED 1 JANUARY 2020 = 100)



Source: Bloomberg, Turkey Statistical Institute, MUFG MENA Research

Turkey's current account shortfall to be small this year, but there is some risk that funding pressures could still materialise. In addition to the persistent weakness in portfolio investment (the 12-month cumulative outflow reached USD12.3bn in early July, the largest reading since early 2016), net FDI inflows have also been weak, falling by 39% y/y January to April to stand at USD1.5bn, and rollover ratios for long-term external loans were largely below 100% in the first four months of this year. Against this backdrop, it appears unlikely that the recent reserve drain will reverse.

Lack of clarity on CBRT's purchases of government debt

At the current juncture, there is uncertainty surrounding the CBRT's purchases of government debt. Policymakers have recently announced that the CBRT would grow its open market operations (OMO) portfolio to 10% of its assets. However, purchases of government debt that the CBRT makes indirectly from the unemployment insurance fund do not fall under this limit, so there is scope for greater balance sheet expansion. We also believe the 10% of assets limit might be revised up in the coming months, even though reserve money is already up by more than 80% compared to a year ago.

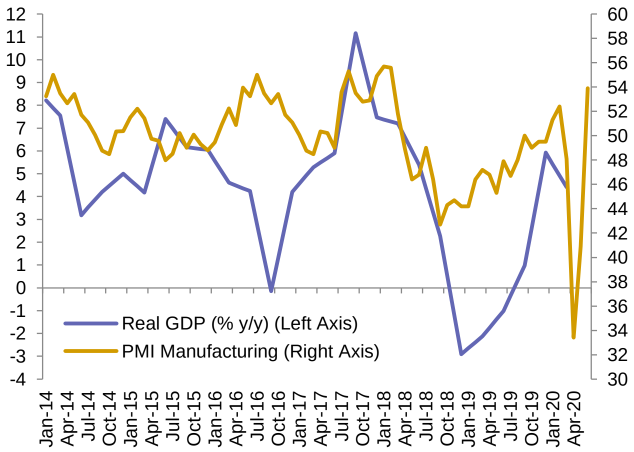
Pace of money supply growth could lead to TRY depreciation

Credit meanwhile is thriving, up by nearly 40% y/y (60% in annualised terms), led by public sector banks. Policymakers appear to see some risk that the pace of money supply growth could lead to TRY weakness, as they have introduced a number of regulatory measures aimed at discouraging FX savings. We view this policy mix could be inflationary, especially in Turkey, which has a history of high inflation and unanchored expectations.

Risks tilted to the downside

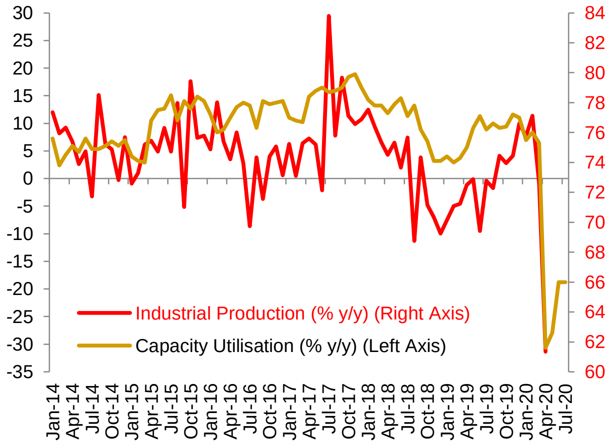
On growth, we see the risks as being tilted to the downside. With short-term external liabilities at USD168bn (north of 20% of GDP), Turkey is still vulnerable to a funding shock. Even a short-lived stop in capital flows could take a large toll on confidence, domestic activity, and the private sector balance sheet, deepening the recession and delaying the eventual recovery. The current account deficit has widened over the past quarter as the recent contraction in exports has been deeper than that in imports. We expect the tourism sector to stay near-shut throughout Q2 and early Q3 2020 – arrivals fell by 99.3% y/y in April and May. Portfolio outflows have accelerated too, while rollover ratios for private sector debt have been below 100%. These pressures have put significant stress on the CBRT's FX reserves, which fell by USD27bn in the first five months of the year. This happened despite a sharp increase in swap borrowing, which should have lifted gross and net FX assets, implying an unsustainable pace of reserve drain.

TURKEY REAL GDP (%) AND PMI MANUFACTURING INDEX



Source: Bloomberg, CBE, MUFG MENA Research

TURKEY INDUSTRIAL PRODUCTION AND CAPACITY UTILISATION (%)



Source: Bloomberg, CBRT, Turkey Statistical Institute, MUFG MENA Research

Economic Weekly Round-up

- **Key data and events in the past week**:
- **Bahrain's** GDP shrank by 1.1% y/y in Q1 2020, with declines registered across hotels and restaurants (-36%), transport and communication (-6.3%), government services (-2.9%), real estate (-0.4%), while the oil sector edged up by 1.8% and manufacturing picked up by 4.8%.
- **Egypt's** PMI stayed below 50 in June, though rising to a four month high of 44.6 from 40.7 in May, as decline in new businesses slowed while output and new orders also clocked four month highs.
- **Egypt's** inflation rate edged higher to 5.6% y/y in June from 4.7% y/y in May, as food prices went up by 0.4% y/y.
- **Egypt's** net foreign reserves increased to USD38.2bn in June from USD36.0bn in May, likely as a result of the first tranche of IMF's standby arrangement.
- **Kuwait's** FDI inflows rose by 2.0% y/y to USD14.7bn in 2019, according to the Central Bank of Kuwait.
- The **Central Bank of Lebanon (BdL)** set a fixed exchange rate of 3,900 Lebanese pounds (LBP) per US dollar (USD) for importers and manufacturers of essential food items.
- **Oman's** Bankruptcy Law came into effect from 7 July – this will provide businesses an opportunity to attempt restructuring against termination.
- **Saudi Arabia** will proceed with plans to double the size and population of Riyadh in the next decade – the government has already committed USD267bn for ongoing and new projects as part of total investments of around USD800bn over the next decade.
- The **Saudi Capital Market Authority (CMA)** will launch a derivatives exchange in Q3 2020 this year, according to local sources, citing the Chairman of the CMA.
- **Saudi Arabia** completed the first batch of its flour milling sector privatisation, with the sale of two companies. The first milling company was awarded to Raha AlSafi consortium at USD 540.1m and the other mill went to Alrajhi-Ghurair-Masafi consortium for USD199.9m.
- The **Central Bank of the UAE (CBUAE)** introduces a new overnight deposit facility (ODF), allowing banks to deposit overnight their surplus liquidity at the CBUAE – this replaces the issuance of one week certificate of deposits, and the interest rate on the ODF will be the main policy rate.
- **Dubai's** government announced a further USD400m worth of economic stimulus measures including an extension of the halving of municipality fees, tourism fees as well as waiving fees charged to private schools for license renewals. The latest round increases the total stimulus from the Dubai government to USD1.7bn.

- **Key focus in the week ahead**:
  1. In **oil markets**, OPEC's JMMC meets and OPEC's latest monthly report.

MENA Market Indicators – Tables

Benchmark Bond Yields (%, Local Currencies)

	Maturity	03-Jul	10-Jul	Change in Yield (bps) Week	MTD*	YTD*
Advanced Countries						
US	10 yrs	0.67	0.64	-2.5	-1.1	-127.3
Germany	10 yrs	-0.43	-0.47	-3.3	-1.1	-28.0
Italy	10 yrs	1.26	1.23	-2.9	-3.2	-18.6
Japan	10 yrs	0.03	0.03	-0.1	-0.1	3.8
MENA Countries						
Bahrain***	3 yrs	3.84	3.88	4.1	-9.4	88.6
Egypt	4 yrs	13.56	14.02	46.8	-159.1	-1.7
Qatar***	10 yrs	2.13	2.07	-6.0	-16.8	-57.7
Saudi Arabia**	10 yrs	2.11	2.12	0.5	1.5	-92.4
Abu Dhabi***	7 yrs	1.54	1.69	15.3	-11.1	-72.2
Dubai***	9 yrs	3.06	3.08	1.4	-5.3	-8.6

Heat Map Legend: Rising Yields – Falling Yields

Note: * Month to Date and Year to Date; ** 10-year swap rate; *** USD denominated

Exchange Rates vs USD

	03-Jul	10-Jul	Change (%) Week	MTD	YTD
Advanced Countries					
US Dollar Index	97.172	96.652	-0.5	-0.8	0.3
Euro Area*	1.125	1.130	0.5	0.6	0.8
Japan	107.510	106.930	0.5	0.9	1.6
MENA Countries					
Egypt	16.100	16.008	0.6	0.8	0.4
Kuwait	0.308	0.307	0.1	0.2	-1.4
UAE 12M Forward	3.680	3.680	0.0	0.0	0.0
Bahrain 12M Forward	0.378	0.378	0.0	0.0	-0.1
Oman 12M Forward	0.391	0.391	0.1	0.1	-0.7
Qatar 12M Forward	3.664	3.656	0.2	0.2	-0.4
Saudi Arabia 12M Forward	3.763	3.763	0.0	0.0	-0.3
UAE Spot	3.673	3.673	PEGGED		
Bahrain Spot	0.377	0.377			
Oman Spot	0.385	0.385			
Qatar Spot	3.641	3.641			
Saudi Arabia Spot	3.751	3.751			

Heat Map Legend: Stronger Currency vs USD – Weaker Currency vs USD

Note: * Exchange rate quoted as amount of USD per currency in line with market convention, other exchange rates are amount per USD

Equity Indices

	03-Jul	10-Jul	Change (%) Week	MTD	YTD
Advanced Countries					
US (S&P 500)	3,130	3,185	1.8	2.7	-1.4
Europe (STOXX 50)	3,294	3,296	0.1	1.9	-12.0
Japan (Nikkei 225)	22,306	22,291	-0.1	0.0	-5.8
MENA Countries					
Bahrain (BB)	1,278	1,314	2.8	2.8	-18.4
Egypt (EGX 30)	10,765	11,072	2.9	2.9	-20.7
KSA (Tadawul)	7,224	7,432	2.9	2.9	-11.4
Kuwait (KSE)	5,131	5,156	0.5	0.5	-17.9
Oman (Muscat 30)	3,518	3,504	-0.4	-0.3	-12.0
Qatar (Doha 20)	8,999	9,337	3.8	3.8	-10.4
UAE (Abu Dhabi)	4,285	4,316	0.7	0.7	-15.0
UAE (Dubai)	2,064	2,086	1.0	1.0	-24.6

Heat Map Legend: Higher Equity Index – Lower Equity Index

5 Year USD CDS Spreads

	03-Jul	10-Jul	Change in Yield (bps) Week	MTD*	YTD*
MENA Countries					
Bahrain	343.38	343.79	0.4	-4.6	167.8
Kuwait	71.78	64.75	-7.0	-9.0	28.1
Qatar	63.48	58.47	-5.0	-14.8	21.8
Saudi Arabia	88.63	103.27	14.6	-4.0	46.4
UAE (Abu Dhabi)	64.74	63.89	-0.9	-10.4	27.8
UAE (Dubai)	189.52	188.82	-0.7	-4.4	97.8

Heat Map: Rising Yields – Falling Yields

Commodity Prices*

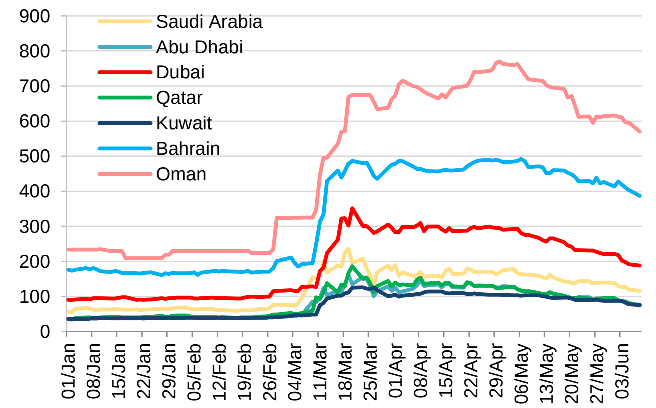
	03-Jul	10-Jul	Change (%) Week	MTD	YTD
Energy					
Brent	42.8	43.2	1.0	5.1	-34.5
WTI	40.7	40.6	-0.2	3.3	-33.6
LNG	1,518.0	1,541.1	1.5	2.5	41.6
Precious Metals					
Gold	1,776	1,799	1.3	1.0	18.5
Silver	18.0	18.7	3.9	2.8	4.9
Industrial					
Copper	6,017	6,412	6.6	6.6	3.9
Steel	490	481	-1.8	-1.4	-18.2
Aluminum	1,614	1,689	4.6	4.3	-6.7
Wheat	490	536	9.3	9.3	-4.1

Heat Map Legend: Higher Commodity Prices – Lower Commodity Prices

Note: * Spot prices or nearest expiring future

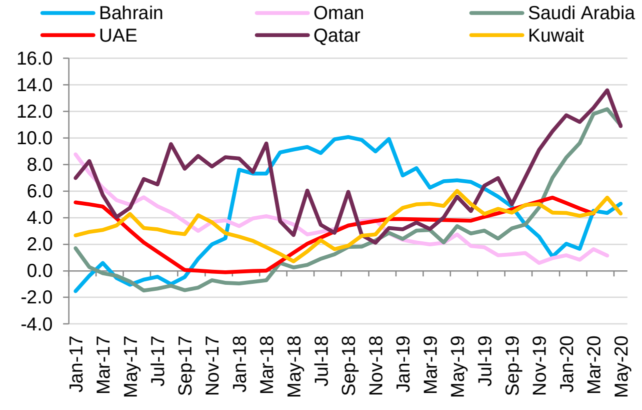
MENA Market Indicators – Charts

CHART 1. GCC 5 YEAR CDS SPREADS (BASIS POINTS)



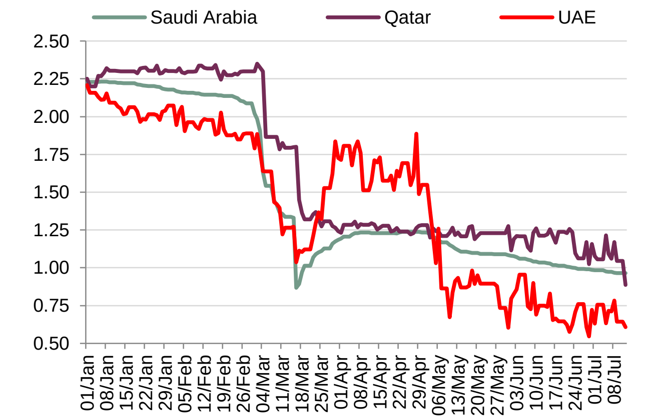
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 2. GCC PRIVATE SECTOR CREDIT GROWTH (% Y/Y)



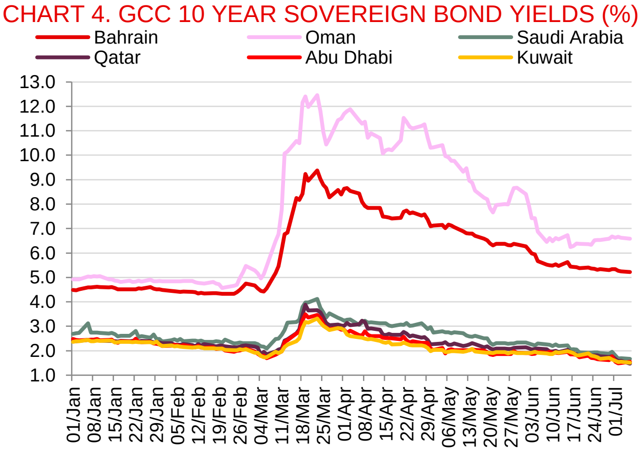
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 3. CORE GCC 3 MONTH INTERBANK RATES (%)



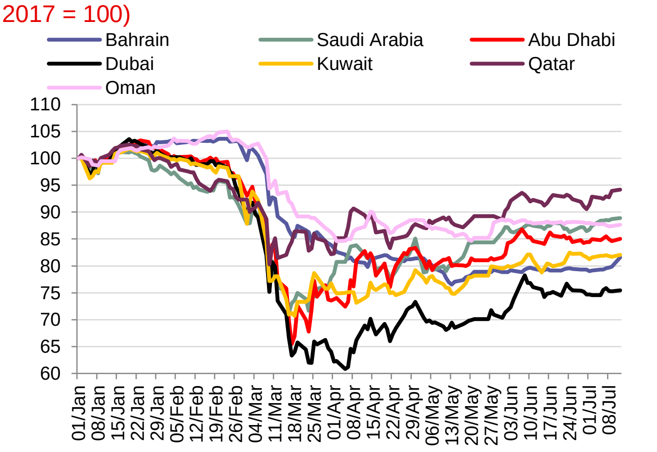
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 4. GCC 10 YEAR SOVEREIGN BOND YIELDS (%)



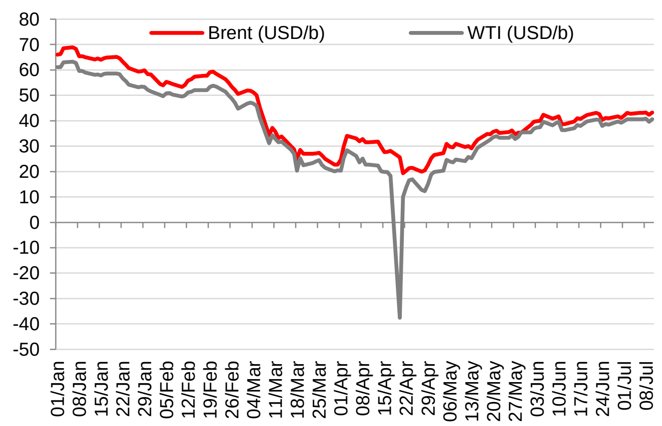
Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 5. GCC EQUITY MARKETS (REBASED JANUARY 2017 = 100)



Source: Bloomberg, CEIC Database, MUFG MENA Research

CHART 6. BRENT AND WTI CRUDE PRICES (USD/B)



Source: Bloomberg, CEIC Database, MUFG MENA Research

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