

FORTIS BANK

Macro Scope

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Weekly Economic and Strategic Review

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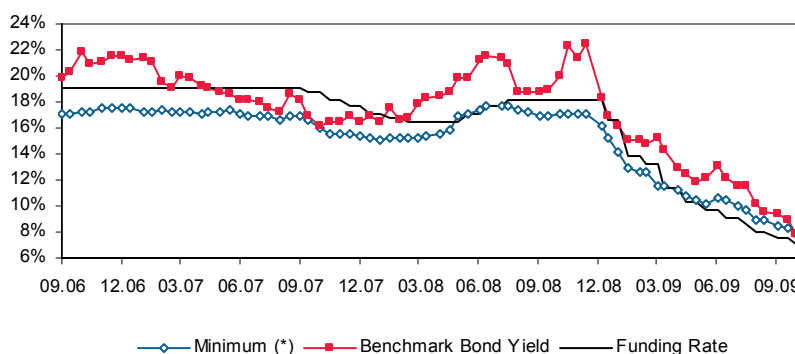
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A Small Bounce Or A Big Bang?

In the beginning of October, the better-than-expected September inflation had reassured confidence that the Central Bank would continue cutting interest rates and the benchmark bond yield regressed to a record intraday low of 7.59% on October 6th. Such low levels were impossible to imagine only a year ago. The main reason behind this drop was the bulky TRY55bn surge in the banking system bond portfolio since the beginning of the year amidst the lack of any expansion in loans. Therefore, as we emphasized in our monthly *Glocal Strategy* released right after the yields touched historical lows, **bond yields have turned more depended on the banking sector dynamics, while the Central Bank funding rate is the most important determinant for the banks.** Herein, one should not overlook the role of the Bank's steady supply of liquidity to the system via different channels in reducing the yields. Recall that in our monthly, we had calculated the lowest boundary for the benchmark bond yield, assuming that the Central Bank does not shift to a more dovish monetary policy stance. The annual funding rate for the upcoming 2 years would be 7.3%, assuming that the O/N rates remain unchanged during 2010, after being cut by 100 bps in the remaining part of this year (including October). This lowest boundary was pretty close to the record low level printed in October 6th. Separately, we also calculated the likely range for the yields in case the Central Bank hints that the easing cycle is about to end. Considering that the long term average of the spread between this funding rate and the 2-year benchmark bond yield is around 2 pp, we said that the benchmark bond yield may settle around 8.5-9.0% after the easing cycle ends. In that context, the post-Inflation Report expectations for the rate decisions were quite important to us. The general sentiment appeared in line with our views discussed in *Macro Brief* ("The Beginning Of The End"). Under the lack of any major change, the Central Bank is likely to end the easing cycle after two or three more rate cuts and would remain on hold until end-2010 if the conditions allow. The bond yields remains elevated at above 8.5% after the Inflation Report.

The Lower Bound For the Benchmark Bond Yield Calculated Via O/N Rate Expectations (*)

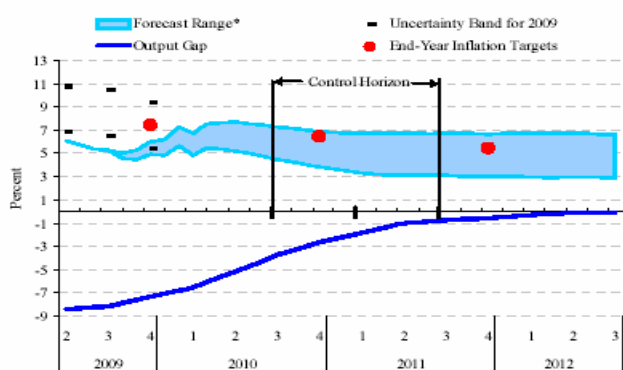


(*) The minimum possible level for the benchmark bond yield is the annual compound yield that corresponds to the borrowing cost in a two-year time span. Source: CBT, Fortis Economic Research and Strategy

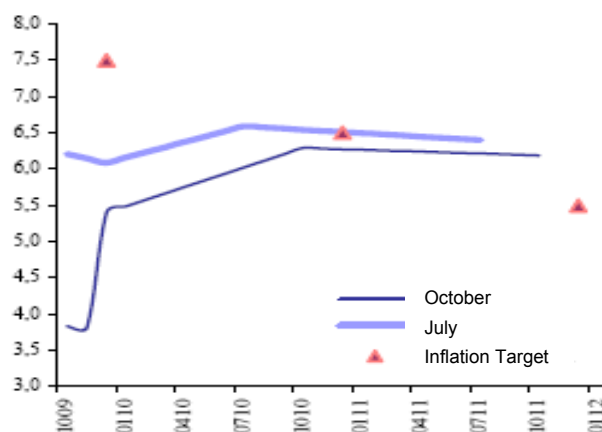
Technically, the current partial correction may lift the yields to a maximum of 9.5%, in the lack of any change in the monetary policy stance. **For a permanent uptrend, a possible surge in the bond yields across the globe would be critical.** Therefore, the recent increase in the U.S. Treasury yields should be monitored closely. **The news that the U.S. Treasury plans to increase the borrowing maturity by raising the shares of 10 and 30-year bonds was influential on this development. Yet, this would unlikely create a sell-off pressure across the board unless the 10-year yield breaches 4%.** In the meantime, there has appeared a new wave of risk aversion nowadays especially in the emerging markets. In first place, this may spur portfolio outflows and put **upward pressure on bond yields** in countries like Turkey. **However, the bonds may benefit from this outlook after a while if the risk aversion stems also from the worries regarding global economic activity, besides being related to the elevated valuations that curb these assets' appeal.**

Having discussed about the repercussions of monetary policy stance on the bond yields, let us continue with the inflation-growth outlook depicted in the Inflation Report. **Our first finding is that there is no major change in the Central Bank's inflation forecasts since the last report was published in July.** The Bank foresees CPI to be 5.5% in end-2009 (previously 5.9%), followed by slight decline to 5.4% (previously 5.3%) by end-2010 and to 4.9% (unchanged), by end-2011. The market forecast is 5.4% for end-2009, 6.29% and 6.19% for the upcoming 12 and 24-month, respectively. This disharmony in the long term forecasts may be one of the difficulties for the monetary policy.

Inflation and Output Gap Forecasts



Inflation Expectations (*)



(*) Constructed by interpolating the inflation expectations for different maturities in the Central Bank Expectation Survey

Source: CBT, Fortis Economic research and Strategy

Our second finding is that there is no important change in the Central Bank's growth projections, either. The output gap (the gap between the potential output and the actual output) forecasts for 2Q09 and 3Q09 remained unchanged at 8.2% and 8.1%, respectively. The output gap is foreseen to recover up to 3% in 2010 and is expected to almost disappear in 2H11, after surging to around 9% this year. In essence, this outlook is in line with the weak recovery scenario that has found support from data so far. **Coming to our third finding, the assumption of a limited amount of further easing and constant policy rate until the end of 2010 as a baseline scenario is not surprising, given the unchanged inflation and growth projections, as well as the fact that the Bank has already come a long way in the rate cut process (rates are reduced by a total 1000 bps over the last one year).** This is also in line with our view that the Bank will slash the interest rates by a total of 50 bps in the rest of the year, with the pace of rate cuts slowing to 25 bps. However, depending on the fresh data, the Bank may also prefer to continue reducing the rates until the next Inflation Report is released (after January meeting).

Our last emphasis would be on the two alternative scenarios described by the Central Bank to trigger a new easing cycle in the interest rates. The first scenario is the surge in capital inflows to emerging markets owing to the relative improvement of credit risk across these countries, resulting in downside pressure

on the F/X rates. In the second scenario, the global growth takes another hit in the upcoming period and this postpones the recovery in the domestic economic activity. In both cases, there would be downside pressure on the inflation and further cuts would be considered in the interest rates. In the current circumstances, these scenarios are not likely.

Summing up, under the lack of a new cycle of weakening in the economy or an abrupt decline in the F/X rates, it has become fairly apparent that we are close to the end of the easing cycle. Therefore, the benchmark bond yield is more likely to be settled in the range of 8.5-9.0% in the forthcoming period. Even though we think that the interest rate hikes would start as late as 4Q10 due to the weak economic backdrop, the risks associated with hefty borrowing need in 2010 may continue weighing on long term bond yields.

Economic and Political Agenda

At home, the most important development will be the October inflation figures to be released on Tuesday. Glancing at the external arena, the U.S. non-farm payrolls will be critical. Separately, while Eurozone and U.S. PMIs will be key for the October performance of economic activity, Fed, ECB and BoE are expected to stay on hold in their monetary policy meetings this week. Based on Reuters' poll, neither of those banks are foreseen to change rates until 3Q10.

Data issuances at Home

Importance	Indicator	Unit	Date of issuance	Fortis (Consensus)
Medium	CBNC-e Consumer Conf. Ind., Oct.	-	Nov. 2 nd , 7:00 GMT	-
Medium	TEA's Preliminary Exports, Oct.	US\$ mn	Nov. 2 nd	9.7
High	CPI, Oct.	%m/m	Nov. 3 rd , 15:00 GMT	2.1 (1.75)
High	PPI, Oct.	%m/m	Nov. 3 rd , 15:00 GMT	(0.91)

Importance	Country	Indicator	Unit	Date of Issuance	Consensus
High	Eurozone	Manufacturing PMI, Oct.	-	Nov. 2 nd , 8:58 GMT	50.7
High	U.S.	Manufacturing ISM, Oct.	-	Nov. 2 nd , 15:00 GMT	53.0
Medium	U.S.	Pending Home Sales, Sep.	% m/m	Nov. 2 nd , 15:00 GMT	1.9
High	Eurozone	Services PMI, Oct.	-	Nov. 4 th , 8:58 GMT	52.3
Medium	U.S.	ADP Employment, Oct.	K	Nov. 4 th , 13:15 GMT	-188
High	U.S.	Non-manufacturing ISM, Oct.	-	Nov. 4 th , 15:00 GMT	51.8
High	U.S.	Fed's Rate Decision	bps	Nov. 4 th , 19:15 GMT	no change
Medium	U.K.	BoE Rate Decision	bps	Nov. 5 th , 12:00 GMT	no change
Medium	Eurozone	ECB Rate Decision	bps	Nov. 5 th , 12:45 GMT	no change
Weak	U.S.	Unit Labor Cost & Productivity, 3Q	% q/q	Nov. 5 th , 13:30 GMT	-4.5 & 5.5
High	U.S.	Non-farm Payrolls & Unemp. Rate, Oct.	K, %	Nov. 6 th , 13:30 GMT	-175 & 9.9

Macro-Economic and Financial Forecasts

Macro Economic Outlook of 2007-2010

	2008	2009f	2010f	2011f
GDP (TRY - bn)	950.1	924.9	1,013.2	1,120.4
GDP (US\$ - bn)	734.9	596.7	645.4	681.6
GDP Growth (y/y % chg)	0.9	-6.0	4.0	5.0
PPI (y/y % chg)	8.1	4.0	5.0	4.0
CPI (y/y % chg)	10.1	5.5	6.5	5.5
Trade Balance (US\$ - bn)	-69.8	-37.7	-56.9	-61.4
Exports (FOB, excl. luggage trade)	132.0	100.8	112.0	112.1
Imports (CIF, incl. gold)	201.7	138.5	168.8	173.5
Current Account Balance (US\$ - bn)	-41.5	-11.3	-25.1	-26.9
Current Account Balance / GDP (%)	-5.6	-1.9	-3.9	-3.9

Financial Indicators Forecasts

	Oct. 30 th	1M	3M	6M	12M	2009	2010
US\$/TRY	1.4823	1.4800	1.5000	1.5600	1.5600	1.4800	1.5600
EUR/TRY	2.2055	2.1900	2.2000	2.2600	2.2500	2.1800	2.2500
FX Basket	3.6878	3.6700	3.7000	3.8200	3.8100	3.6600	3.8100
EUR/US\$	1.4879	1.4800	1.4700	1.4500	1.4400	1.4700	1.4400
O/N	6.75%	6.50%	6.25%	6.25%	6.75%	6.25%	7.75%
Benchmark Bond	8.60%	9.00%	8.50%	8.50%	10.00%	8.70%	10.50%

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