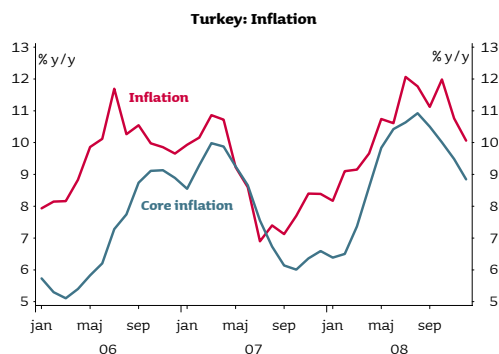


Turkey: is it safe?

Like most other emerging-market currencies, TRY went through the wringer in 2008, closing the year down by more than 23% against EUR. The first monetary-policy meeting of the year offers an opportunity to take an overall look at Turkey's prospects and ask ourselves: "is it safe?" as Laurence Olivier asked the unsuspecting Dustin Hoffman in *Marathon Man*. In keeping with Hoffman's reply in the film we must say that there are both pros and cons. As before, the Bank's overall approach to the financial markets is that investors should basically think defensively (cf. our latest strategy paper about the Q1 prospects [Dense fog ahead](#)), and a look at the global and local factors that determine the return on TRY-denominated bonds reveals that risk has increased - the tail of the distribution has widened. So even if we maintain our BUY recommendation for TRY-denominated bonds, risk is somewhat higher than just six months ago - and investors who have not reduced their exposure to TRY should take an extra look at their portfolios.

Fundamental development

During recent months, the trend across the world has been clear: economic growth and inflation have plummeted at a rate that has taken most by surprise.

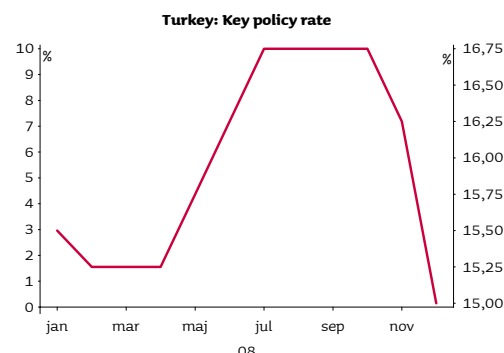


Over the closing months of 2008, the Turkish inflation rate fell from almost 12% y-o-y in October to 10% y-o-y in December - and the fact that commodity prices remain low in combination with a sharp slowdown in growth mean that the inflation rate may slow down more - to about 7% in the course of 2009.

For economic growth has also imploded, and the Turkish economy grew at a mere 0.5% y-o-y in Q3 2008. We expect the growth rate for full-2008 to come to about 2½% y-o-y and a measly ½% y-o-y in 2009 - and this succeeds years of impressive growth rates.



The above prompted the Turkish central bank (CBT) to perform another handbrake skid. Having been lowered in early 2008, interest rates were raised by 150 bp between April and July - and in November the CBT began its latest relaxation cycle. A tentative start of a 50 bp cut was succeeded by an impressive cut of 125 bp to 15% in December - and at the meeting today, 15 January, we expect another cut, of 75-100 bp. All in all, we expect that the central bank rate may be as low as 12% before the end of the year - the lowest level in recent times.



Below we set out the pros and cons for TRY-denominated bonds, given the developments outlined and the global background.

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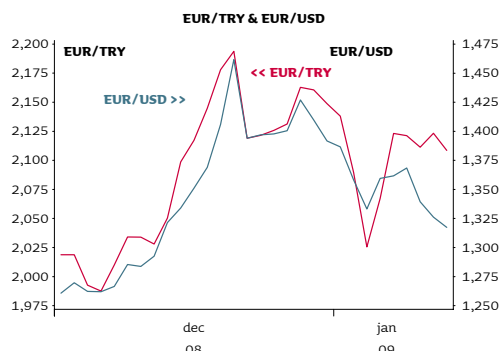
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Yes, it's safe, it's very safe – it's so safe you wouldn't believe it!¹

Falling yields: the aggressive start of interest-rate cuts led to considerable falls in long-term yields - from about 19% to about 13% - which resulted in fair gains in market value. It has therefore been a good thing to invest at the long end of the curve, and more potential may be left there - although it will probably materialise at a slower pace.

The central bank got away with it! When interest rates were lowered by 50 bp in October, most analysts (including ourselves) made the sign of the cross, mumbling about policy error, capital flight and various other things. However, the credit crisis and the violent economic slowdown justify a shift of focus away from inflation - and the latest economic indicators confirmed that the CBT was right. Inflation expectations have, indeed, continued to fall and so far the CBT has come out without losing credibility (unlike another major European central bank).

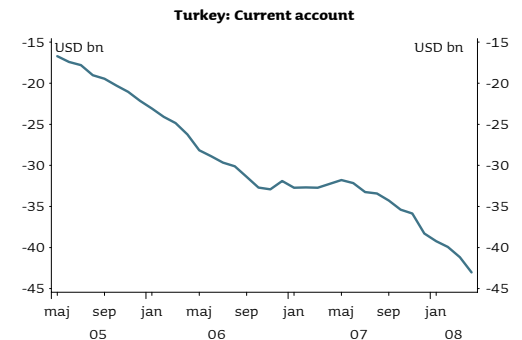
Support from a dollar depreciation: at certain periods there has been close correlation between the dollar and TRY - and it has been exceedingly close during the preceding months. A stronger dollar would thus result in a stronger TRY - and we expect the dollar appreciation to continue. We expect the EUR/USD to reach 1.20 within the next three months.



The current-account deficit is shrinking: one reason why TRY is generally regarded as highly

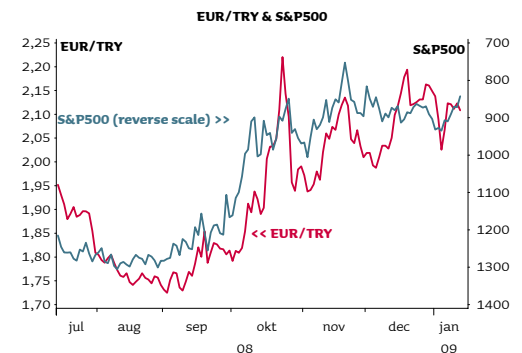
¹ Not knowing what the question means, Hoffman tries two different replies - and neither of them is to the liking of the questioner

risky is the appreciable current-account deficit. The deficit has been growing steadily in recent years, on a combination of strong growth and high energy prices, and it reached 6% of GDP in 2008. Both of the factors have turned round, and we expect that the deficit may be reduced further - to about 3%-3.5% of GDP.



No, it's not safe, it's very dangerous – be careful!¹

Still jittery! The main reason for being concerned about TRY is our expectation that the general investment environment will remain jittery. It is still the global sentiment that drives TRY (cf. the chart below). This is described in more detail in our strategy paper for the first quarter of 2009 (see link above), so interested readers are referred to that paper.



The central bank does not pay heed to TRY: a consequence of CBT's change of focus from inflation to growth is that the CBT is now more or less explicitly signalling that it is not concerned that the currency may depreciate - perhaps rather the opposite. The CBT assumes that the spill-over from a weaker currency on inflation will be very limited. For one thing, this increases the risk of policy errors (runaway inflation) but perhaps the main thing is the

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risk that Turkey will find it more difficult to obtain sufficient currency to finance its current-account deficit which is still fairly big, after all.

Conclusion

Needless to say, the foregoing paints a somewhat murky picture for the prospects of Turkey - and it is perhaps also the main message of this paper (we are repeating ourselves): after a number of years when two-digit returns were the rule rather than the exception, there has been a paradigm shift. Risks are much bigger, and the investment case for the emerging markets in general has deteriorated. Even if we maintain our BUY recommendation for TRY-denominated bonds, it is thus clear that exposure to TRY at present should be somewhat smaller than just six months ago.

With regard to the currency alone, we currently do not recommend investors to take up long TRY positions. Even if an EUR/USD rate at 1.20 would result in fair downward pressure on the EUR/TRY rate (other things being equal), we believe that the USD/TRY rate may rise further from its present level - perhaps towards 1.75. That would mean an EUR/TRY rate of about 2.1 in three months - and in view of the risks attached to the currency (and the fact that such a position would not have the hedge involved in bonds when yields fall), the risk in our forecast seems too big for the return (3-months forward currently trades at around 2.20). In general we recommend investors to scale down their TRY investments, if the EUR/TRY rate should again approach 2.0.

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