Renaissance Capital

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The Focal Point
Equity Research

9 October 2020

The Focal Point
Talking Turkey

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We refresh our view on Turkey. Our top picks are Ulker Biskuvi (ULKER), Medical Park (MPARK), Coca-Cola Icecek (CCOLA), Sok Marketler (SOKM), Sabanci Holding (SAHOL), Koc Holding (KCHOL), Tupras (TUPRS) and Turk Telekom (TTKOM). Turkey is one of the worst performers in MSCI EM in 2020, down 33% vs MSCI EM which is up 0.2%. We flip our Underweight on Turkey to a trading Overweight (Neutral for those who do not like trading calls).

A growing list of dislikes…

Investors have a long and growing list of reasons to be wary of investing in Turkey. The shortlist includes the hollowing out of state institutions, geopolitical forays (Libya, Syria, Transcaucasia, the Eastern Mediterranean) and associated sanctions risk, as well as continued attempts to reignite the credit cycle by pushing rates too low. Undermined by an insufficient buffer of FX reserves and frequent currency sell-offs followed by emergency rate hikes, the promised upside from disinflation seems as far away as ever, while a former head of the stats office has described Turkish economic data as "detached from reality" (he is now an opposition politician). Investor caution has been right: MSCI Turkey has lost three-quarters of its value in dollar terms in just seven years since 2013 (only Greece has done worse in MSCI EM), hitting a 17-year dollar low in recent weeks. The market is the fourth-worst performer in MSCI EM in 2020, down 33% vs MSCI EM which is up 0.2%.

…but stepping back from the brink once more?

The question for investors is whether there is a short-term trade in the making. We would argue potentially yes. President Erdogan has a history of brinksmanship. We think there is a good chance that Turkey will avoid getting sucked into an all-out war between Armenia and Azerbaijan, while recent signs of de-escalation in the Eastern Mediterranean, including talks between Greece and Turkey, should avoid EU sanctions being imposed (at least until December). At the same time, policy is being tightened which (with another hike) ought to support the lira, particularly if a Joe Biden victory in the US presidential election brings with it a more positive EM backdrop – via a weaker dollar/easing of global trade tensions – which we would see as positive for EM risk appetite.

A trading buy?

How sustainable a rebound in Turkey might be is debatable, but with foreign ownership of the equity market at a 15-year low, the equity market trading at a 15-year relative 12M forward PER valuation low vs MSCI EM (5.8x vs 14.7x, a 60% discount) and the currency as cheap as it has been for 25 years on our Real Effective Exchange Rate (REER) model, we think the potential for a short-term rebound is there. We flip our Underweight on Turkey to a trading Overweight (Neutral for those who do not like trading calls).

Top picks

Our top-picks are ULKER, MPARK, CCOLA, SOKM, SAHOL, KCHOL, TUPRS and TTKOM.

Our top picks

	Ticker	Rating	TP, TRY	CP, TRY
Ulker Biskuvi	ULKER	**BUY**	33.2	23.8
Medical Park	MPARK	**BUY**	24.7	17.4
Coca-Cola Icecek	CCOLA	**BUY**	60.7	46.3
Sok Marketler	SOKM	**BUY**	17.6	12.2
Sabanci Holding	SAHOL	**BUY**	11.6	8.4
Koc Holding	KCHOL	**HOLD**	19.2	14.5
Tupras	TUPRS	**BUY**	105.0	80.3
Turk Telekom	TTKOM	**BUY**	10.0	7.3

Priced as of close 8 October 2020

Source: Bloomberg, Renaissance Capital estimates

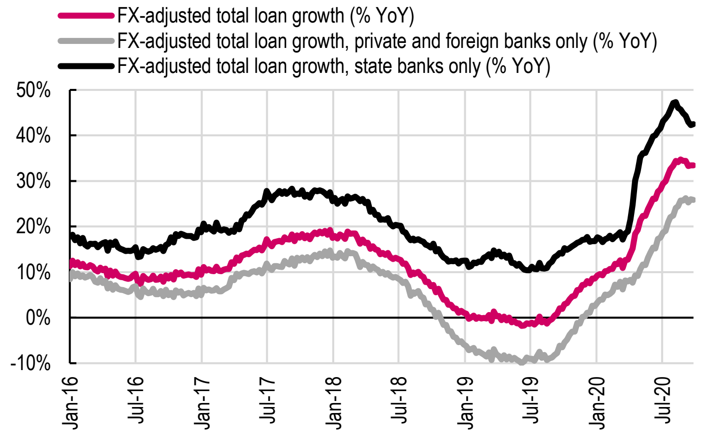
Turkey – wrap-up

Politics / Geopolitics

Investor sentiment: Very poor

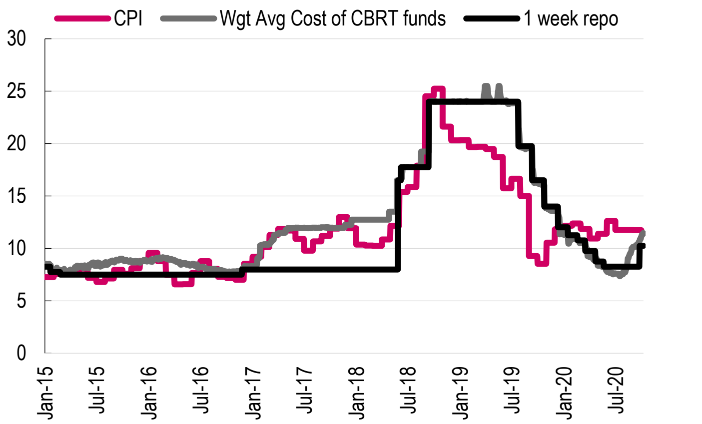
The government is widely seen as eroding trust at many levels – the hollowing out of state institutions, geopolitical forays (Libya, Syria, Transcaucasia, Eastern Mediterranean energy exploration), continued attempts to reignite the credit cycle by pushing rates too low and an insufficient buffer of FX reserves, resulting in frequent currency sell-offs, are all cited by equity investors as reasons to avoid Turkey. Policy tools to support the economy are widely regarded as limited.

Figure 1: Turkey – banks FX-adjusted loan growth



Source: BRSA, Renaissance Capital

Figure 2: Turkey inflation and central bank rates, %



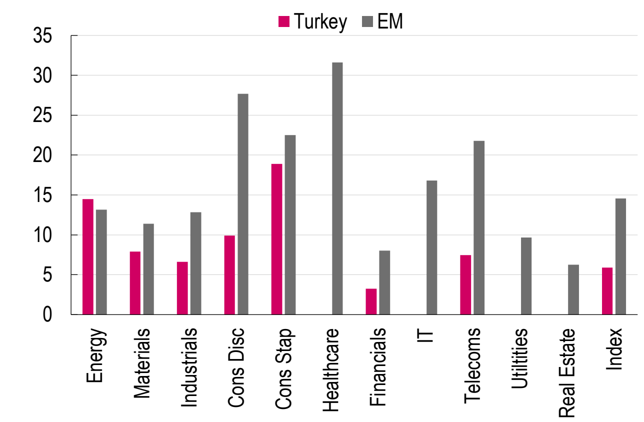
Source: Bloomberg, Renaissance Capital

The poor performance of the equity market has seen Turkey's weighting in MSCI EM decline from 5.6% at its peak in April 2000, to just 0.36% (or less than one stock position for many GEM funds).

Foreign ownership of the equity market is down to 49.9%, a 15-year low. The equity market is trading at a 15-year relative 12M forward PER valuation low vs MSCI EM (5.8x vs 14.7x, a 60% discount) and the currency is as cheap as it has been for 25 years on our REER model (Figure 12).

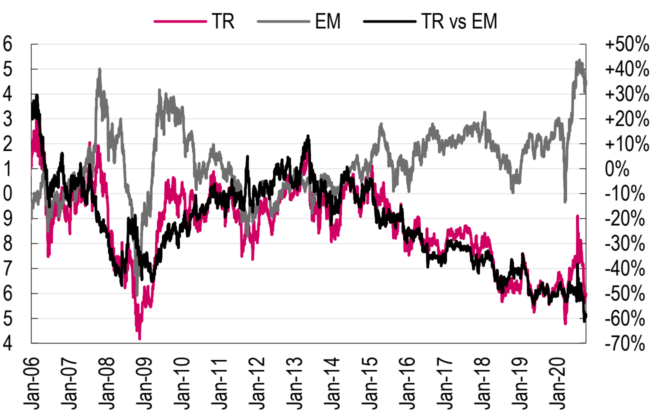
At current 10-year lira government bond yields (currently 13.6%), a 10-year regression of bond yields vs a 12M fwd PER since 2010 points to a 7.3x 12M fwd PER (vs the current 5.8x), 26% above current levels (Figure 7).

Figure 3: 12M fwd PER by MSCI sector, x



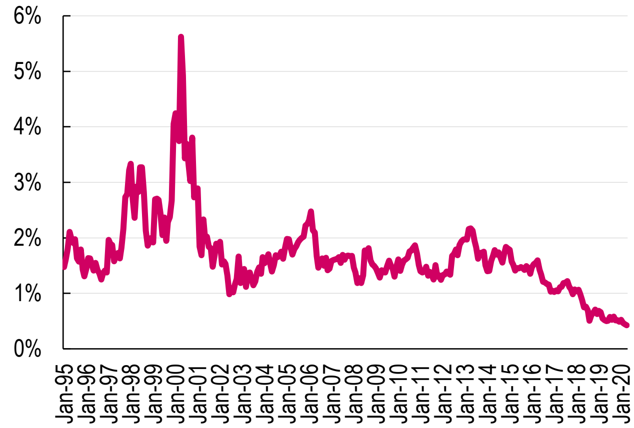
Source: Bloomberg, Renaissance Capital

Figure 4: MSCI indices 12M fwd PER (x, lhs) and relative (%, rhs)



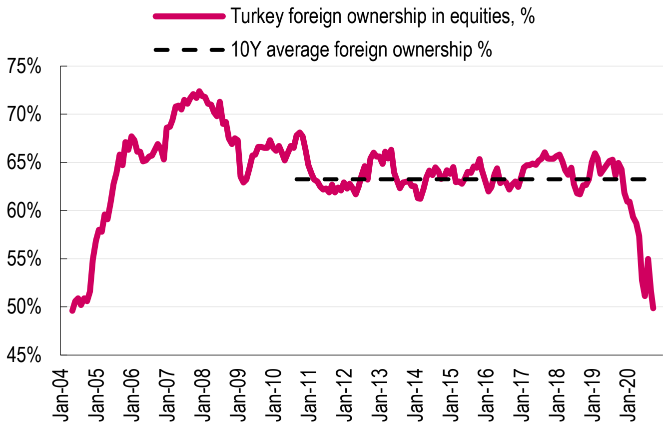
Source: Bloomberg, Renaissance Capital

Figure 5: Turkey weight in MSCI EM, %



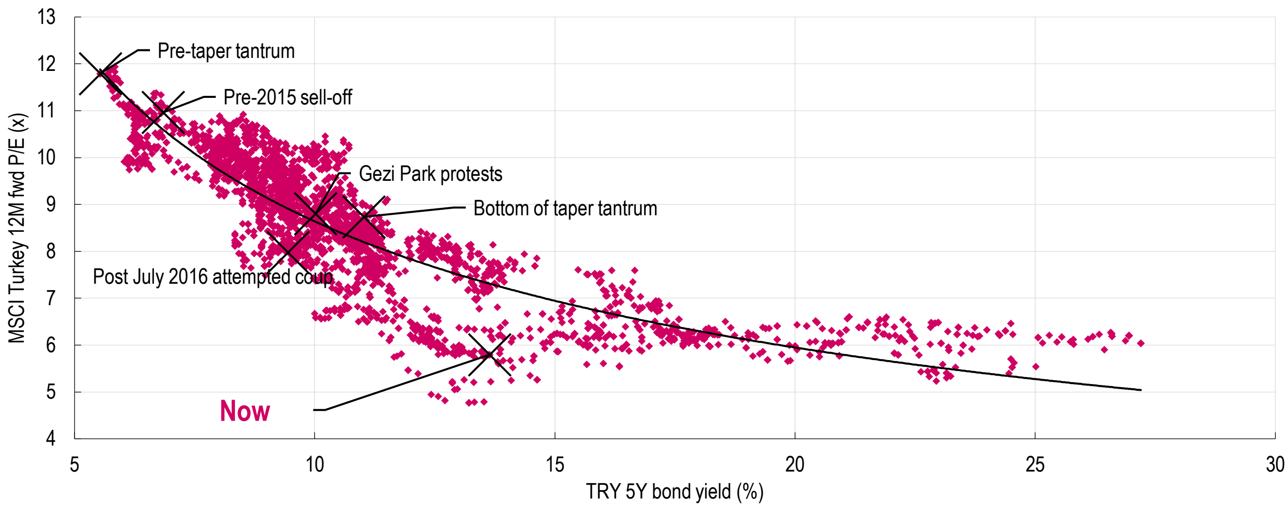
Source: MSCI, Renaissance Capital

Figure 6: Turkey – foreign ownership of the equity market



Source: MKK

Figure 7: MSCI Turkey 12M fwd P/X (x) vs TRY 5Y bond yield (%)



Source: Bloomberg, Renaissance Capital

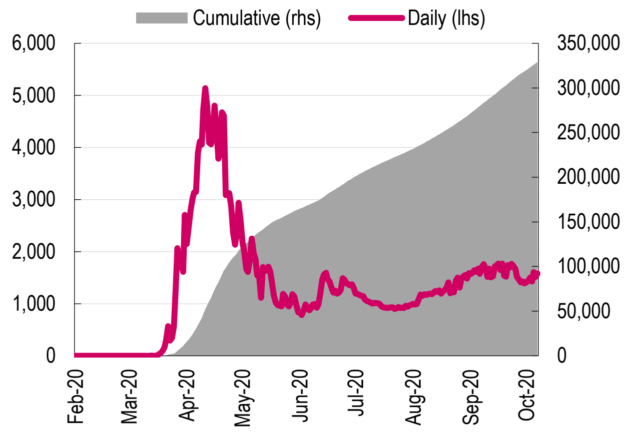
The government's aim is to realign the economy from consumption to exports over the coming three years to position Turkey for a potential repositioning of global supply chains out of China and closer to the EU. More industry-specific regulations are likely to support certain businesses (import substitution as well as supporting exports), but this is easier said than done – in a world of spare capacity, Volkswagen has dropped its plans for a new factory in Turkey, and attempts earlier this year to reignite the domestic credit cycle undermine the authorities' export-focused rebalancing argument.

In order to reassure confidence and improve credibility and competency, one political analyst we spoke to suggested that new ministers could potentially be announced from a more pro-business private sector background.

COVID-19 measures

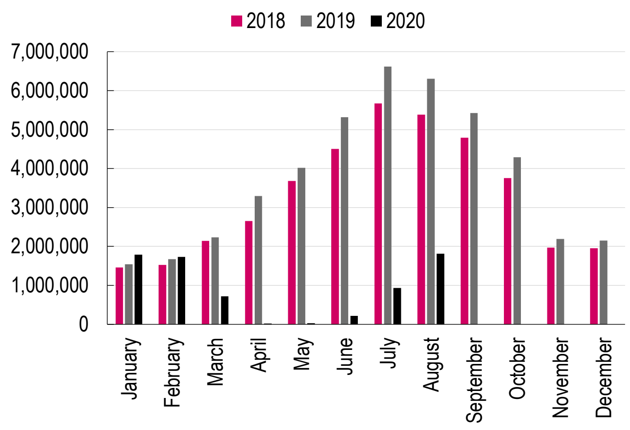
Demographics and recent healthcare upgrades helped avoid a full blown COVID-19 health crisis. Meanwhile, the economy avoided being shut down despite curfews and the industrial economy was kept up and running. However, COVID-19 numbers have been under-reported since late-July, when numbers started to be reported, excluding nonsymptomatic cases, presumably to try to save the tourism season (with only limited success: with only 7.3mn arrivals in 8M20 vs 31.0mn in 8M19).

Figure 8: Turkey – daily and cumulative COVID numbers



Source: John Hopkins

Figure 9: Turkey – monthly foreign visitors



Source: Ministry of Culture and Tourism

Energy

Turkey's recent gas search in disputed areas in the Mediterranean has added another item to the list of disputes with the EU. Some EU countries have threatened sanctions on Turkey regarding this conflict, yet, there is no unanimous decision among EU leaders so far, with Turkey having a critical role in keeping refugees under control. The recent EU summit agreed to review Turkey's behaviour in December, pushing back the threat of sanctions and perhaps tying a negotiated outcome with closer trade relations.

On the other hand, Turkey sees heavy energy dependence as a key external vulnerability. The strategy is to become more self-dependent, diversify import sources and develop as a regional energy hub. At current prices, the economics of new Eastern Mediterranean gas projects would probably be questionable without Turkish demand (as an anchor market).

Azerbaijan/Armenia

Armenian foreign minister Zograb Mnatsakanyan will visit Moscow on 12 October and OSCE Minsk Group co-chairs, France, Russia and the US, will meet Azerbaijan's foreign minister Jeyhun Bayramov in Geneva this week, to discuss the Nagorno-Karabakh conflict. We see this as an encouraging step toward possible de-escalation between the two sides since fighting began on 27 September and preventing a full-blown regional war. NATO's general secretary is in Ankara this week once again to try to get things back on track on the dispute with Greece and the regional conflict between Armenia and Azerbaijan.

The EU

The EU has been dangling for the past five years an upgrade of Turkey's EU customs union (but Germany has stopped it progressing). The original customs union was an interim arrangement on Turkey's path to EU membership and covers only industrial goods. With EU membership not on the agenda, the customs union could do with a rethink (the EU has recently stated that Turkey continues to move further way from the EU with serious backsliding in the areas of democracy, rule of law, fundamental rights and independence of the judiciary, and noted that negotiations have effectively come to a standstill and no further chapters can be considered for opening.

One political analyst told us that upgrading Turkey's customs agreement is a bit like reforming the WTO, all sides agree that changes are needed but getting it done is the issue. For Turkey the issue is that it is locked in to trade policy with no say. One option would be to widen the agreement to include agricultural products and services. Yet, both look unlikely for now as Turkey wants to protect its agri-economy and a comprehensive service agreement would need to bring Turkey in to the single market sector by sector, but that needs material adoption of the acquis, and submission to the European Court of Justice (ECJ), which Turkey is as reluctant as the UK is to agree to. Post-Brexit, Turkey loses an important supporter in the EU; however, we believe the Turkish government is aware that it has to reset the EU relationship for better macro dynamics, FDI and exports. So, all in all, any meaningful upgrade of the customs union appears unlikely to us with this EU and this Turkish government.

We are now in the final quarter before the end of the transition period for the UK. Note that Turkey has a large surplus with the UK (almost $6bn in 2019 or 0.8% of GDP). The UK's security role in Europe and the EU's eastern border vulnerability ought to make Turkey more important security-wise post Brexit. In the absence of an EU/UK trade agreement, Turkey cannot benefit from preferential exports to the UK. The UK cannot unilaterally liberalise its imports from Turkey and would have to treat Turkey the same as any other non-trade agreement country under World Trade Organisation (WTO) rules until it signs a trade agreement with Turkey, and it can't do that unless it signs one with the EU.

Domestic political outlook

The AKP (Justice and Development Party) has to rely on the MHP's (Nationalist Movement Party) support to stay in power. No elections are scheduled until 2023 and the probability of early elections should be seen as very low now, given the AKP's weaker voter base and continuing macro challenges. Actions that might have raised support levels for the AKP (tension in the Mediterranean, Libya, Syria, converting the Aya Sofya to a mosque, gas discovery, etc) do not seem to have improved the AKP's popularity.

Ali Babacan (former economy minister from the AKP) and Ahmet Davutoglu (former prime minister from the AKP) have both established their own party' networks countrywide and have become very vocal against the AKP's recent policies. Recent opinion polls show that both parties have reached a vote base of 1-2%.

On the other hand, the opposition mayors (e.g. in Istanbul and Ankara) have been moving up in the polls. Separately, the IYI Party, the new nationalist party, is also picking up voters (vs MHP). Two years into the new presidential system (without French or US-style checks and balances) and the AKP's vote continues to erode. If the economy gets weaker, opposition candidates could do better in the polls. There has been some discussion about moving back to a parliamentary system, but we think this is a low probability for now.

US election

President Trump has viewed President Erdogan favourably despite several challenges. In our opinion, President Erdogan overly personalises policy with political leaders, most likely taking the view that he's a strong negotiator. A Biden victory would be felt in Ankara, with Biden having described Erdogan as an "autocrat" who "has to pay a price" and should be defeated via the electoral process. Meanwhile, there are renewed calls from Congress for sanctions on Turkey.

Rates and inflation

Turkey has been hiking rates: the headline one week repo rate, which was increased by 200 bpts from 8.25% to 10.25% on 24 September; the $/TRY swap rate, which was increased by 150 bpts from 10.25% to 11.75% on 9 October; and the weighted average cost of central bank funding for the banks, which has been rising from a low of 7.3% in mid-July to 11.6% currently. We see the latest tightening step by the Central Bank of the Republic of Turkey (CBRT) as signalling that another rate hike at the MPC meeting on 22 October is likely if the lira continues to underperform EM currencies. With inflation of 11.75%, real rates are still slightly negative. Consensus sees only slight declines in inflation to 11.3% by end-2020 and 10.8% by end-2021, making Turkey one of the few emerging markets with persistent double-digit inflation.

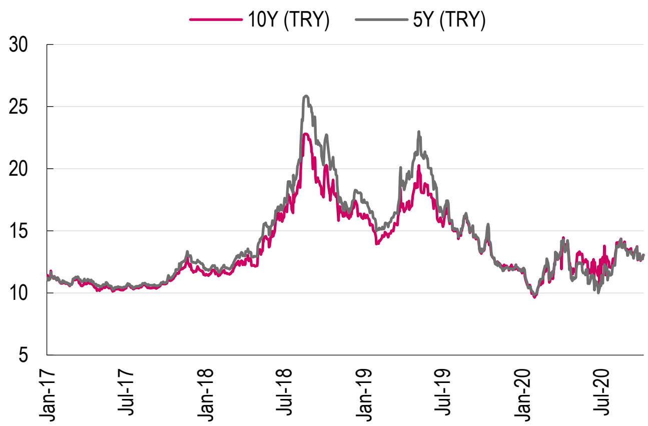
Foreigners bought a total of $610mn Turkish assets during the week ending 2 October, after the CBRT's and the Banking Regulation and Supervision Agency's (BRSA) normalisation efforts – the first sizeable inflow to Turkish assets since 2018. But the currency has yet to stabilise. Why? Retail investors are not convinced yet given the yield in lira-denominated deposits along with increased geopolitical risks. Lira-denominated deposit rates increased to as high as 13% recently vs 6-7% during the summer. Another 100-300-bpts increase towards 15% along with calmer geopolitics should be enough to stabilise the lira, in our opinion (and perhaps even appreciation towards 7.50 or below against the dollar).

Dollar funding costs have come up over the course of the year: Turkey issued a 2025 dollar eurobond in February at 4.45%, the yield traded up to 9.47% in April, but Turkey recently returned with a 2025 dollar eurobond yielding 6.40% on issue.

Figure 10: Turkey $ eurobond yields

Source: Bloomberg

Figure 11: Turkey TRY government bond yields



Source: Bloomberg

Turkey's lira is the cheapest it's been in 25 years (again)

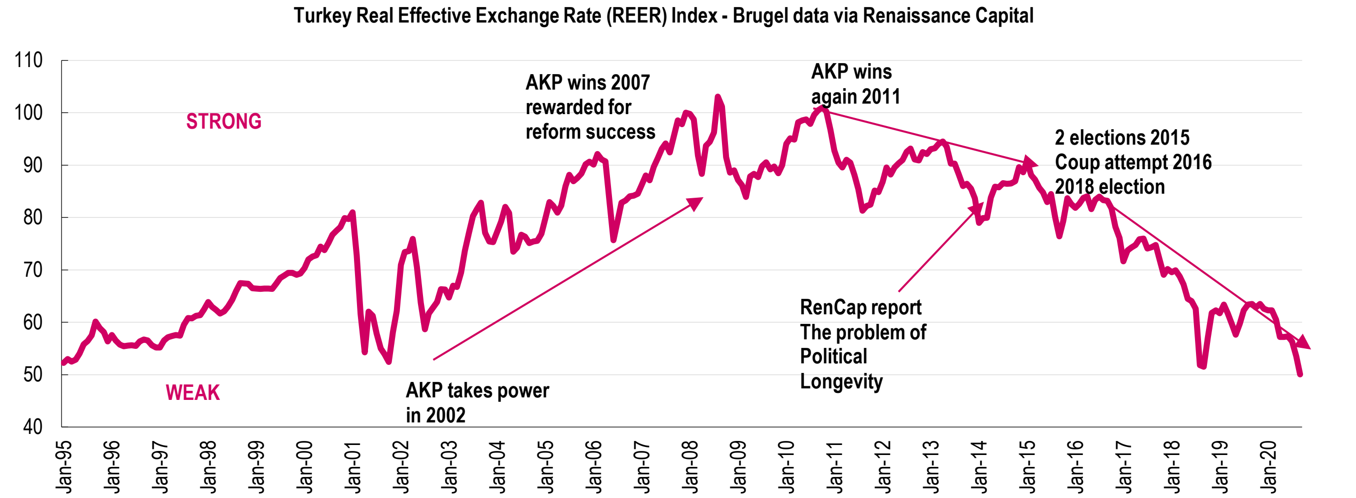
Comment by Charles Robertson (first published 29 September)

Didn't you read that before? Yes you did in 2018. The lira did bounce a month later. The table at the bottom shows the lira is 34% undervalued to its 1995-2020 average, and at 7.84/$ is weaker today than the 7.62/$ level (in today's money) seen in September 2018.

You didn't get a note (or tweet) from me about Turkey's rate hike last week because I wasn't convinced it was enough to support the lira. The follow-on decision to ease up the FX restrictions was encouraging… although Turkey's authorities might need to learn that if you restrict an FX market in bad times, it's not that easy to tempt money back in when you remove/reduce those restrictions (see also Nigeria). Now geopolitics (or perhaps that easing of FX restrictions) has hurt the lira. But tinkering around like Turkey is doing isn't going to turn around the decade-long negative trend.

All the currency gains of the AKP's first term (2002-2007), when the currency appreciated very significantly in real terms, have disappeared.

Figure 12: TRY in REER terms, 1995-2020



Source: Bruegel, Renaissance Capital

Those gains were broadly maintained in 2007-2011, when Turkey adopted a pro-active (ie, high spending and lending) response to the global financial crisis.

The positive story was already being undercut in 2013 when we published our report *The problem with political longevity*, about leaders who stay in power too long – this was a year before Russia/Ukraine kicked off, and just as the negative impact of Zuma's period in office on South Africa's (SA) economy was becoming more and more obvious. The rating agencies disagreed. Fitch upgraded Turkey to investment grade in 2012, Moody's followed in 2013 and S&P awarded its highest ever rating to Turkey of BB+ in 2013 as well.

Our key point was that political leaders who stay in power too long (beyond 10-15 years) almost all fail to move with the times, corruption becomes a bigger problem and this was concerning for our key EEMEA markets. It is a good reason to be concerned about "President for Life" Xi in China, although so far he's only been there seven years.

Anyway – back to Turkey. The lira is now the cheapest it has been since 1995 – on our REER Index or in today's money – and there is room for a small bounce. As we said in 2018, a currency this cheap is good for the current account (C/A), and were it not for the death of 2020 tourism and a surge in gold imports, the C/A might have been in balance this year. A cheap currency should also be good for foreign direct investment (FDI) but interestingly, Volkswagen has now given up on plans to build a factory in Turkey. Eventually even a cheap currency is not enough to attract direct investors.

The nominal return for owning lira is now double digits – although barely positive in real terms with inflation at 12%.

More problematic for Turkey is that a convincing currency rally is harder to achieve, when even the 2018 crisis failed to provoke a shift in the longer-term trends. We argued in early 2019 that Turkey could move to an export led growth model, suppressing consumption by limited bank lending. Instead President Erdogan tried to have both high credit growth and high export growth – and inevitably this was going to provoke a problem – which turned out to be inflation, a consequence we flagged in February 2020 which was the last time I attempted to say anything positive about Turkey's prospects. When your inflation rate is 10 percentage points above your peers, your currency is liable to take the strain – as it has done this year. Turkey's finance minister this morning reiterated the model has not changed – he is looking for GDP to accelerate from 0.3% in 2020 to 5.8% in 2021.

If the markets actually trusted Erdogan, then the currency could strengthen considerably from here. But they don't. So yes, we could see a 5% bounce in the lira, maybe even 10% if interest rates are hiked again, and there is a short-term trade that could be profitable. You have to assume that Erdogan won't be so furious about the failure of last week's hike that he doesn't overrule the CBRT.

The assets that appear less risky for a debt investor are the eurobonds. A 7.7% yield on the 2047 eurobond is pretty interesting … above SA and not far off Kenya. I was comparing Kenya to Turkey on my first work trip to Nairobi a decade ago (entrepreneurial, oil-importer, tourism beneficiary, C/A-deficit country, marathon running success – actually not that, Pheidippides was Greek), but I'm surprised Turkey's yield of 6.5% on the 2025 is so close to the 7.3% of the Kenya 2028, and so much higher than the 4.2% of SA's 2025.

Fundamentally, Turkey does not have SA's 30% unemployment, it has a diversified economy with good companies in a customs union with the EU and cheap wages and ... basically any other president is likely to be an improvement on Erdogan. In SA by contrast, we believe politicians like Malema and Zuma, tell us SA could do much worse than have Cyril Ramaphosa in power. SA pension funds close to 100% of GDP, while Turkey's are closer to 2% of GDP, are a massive vital difference of course.

Vikram's point to me this morning is that Erdogan could still take Turkey a lot further down a negative path. That's fair. He's president until at least 2023. On the other hand… I think EM debt is going to get a massive bid from 2021 as global fund managers price out trade war risk and price in dollar weakness.

Conclusion

The lira is the weakest it has ever been since 1995. For the second time in three years. A short-term 5-10% bounce in the lira may not last as long as the last 2018/19 bounce. Dollar debt may be the less anxiety-inducing way to trade Turkey – but even that needs to be premised on benign global appetite for EM fixed income, rather than any assumption of a significant change in Turkish policy. Also you have to decide to ignore a fair number of risks geopolitically: Armenia/Azerbaijan, Libya, Greece/oil exploration, Syria, PKK, EU/migrants, US sanctions risk, etc.

Figure 13: EM FX and REER

	Current FX rate vs $	FX rate implied by LT average REER	FX rate if REER falls to previous lows	Date of REER low	LT average divided by current rate	IMF 2019E C/A (% GDP)	IMF 2020E C/A (% GDP)	Standard deviations away from historical average	Yvonne's* avg. REER 9/19 estimate	RenCap 20YE forecast	One-year local currency yields	Latest CPI (% YoY)	CPI (date)
Philippines	48.3	**60.8**	85.8	Feb-04	**1.26**	-0.1	-2.3	1			1.8	2.3	30/09/2020
China	6.71	**8.40**	11.6	Apr-95	**1.25**	1.0	0.5	1			2.6	2.4	31/08/2020
Czech Republic	23.0	**28.0**	43.6	Jan-95	**1.22**	0.0	-2.1	1			0.1	3.3	30/06/2020
India	73.2	**87.9**	108	Nov-96	**1.20**	-1.1	-0.6	1			3.5	6.7	31/08/2020
Egypt	15.7	**18.8**	29.0	Dec-03	**1.20**	-3.6	-4.3	1	18	16	13.5	3.4	31/08/2020
Thailand	31.1	**35.7**	52.4	Jan-98	**1.15**	6.9	5.2	1			0.5	-0.7	30/09/2020
Peru	3.58	**3.88**	4.41	Jul-07	**1.08**	-1.4	-0.9	1			0.5	1.8	30/09/2020
Saudi Arabia	3.75	**4.05**	4.94	Mar-08	**1.08**	6.3	-3.1	0		3.75	0.9	6.2	31/08/2020
Indonesia	14,700	**15,791**	41,266	Jun-98	**1.07**	-2.7	-3.2	0			3.6	1.4	30/09/2020
Qatar	3.69	**3.92**	5.03	Dec-03	**1.06**	2.4	-1.9	0		3.69	1.4	-4.1	31/08/2020
Poland	3.80	**3.98**	4.81	Nov-97	**1.05**	0.5	0.2	0			0.0	3.2	30/09/2020
UAE	3.67	**3.81**	4.38	Nov-07	**1.04**	7.4	1.5	0		3.67	0.8	-2.6	31/08/2020
Korea	1,147	**1,186**	1,839	Jan-98	**1.03**	3.7	4.9	0			0.6	1.0	30/09/2020
Hungary	303	**311**	419	Apr-95	**1.03**	-0.8	-0.1	0			0.7	3.4	30/09/2020
Taiwan	28.6	**29.4**	34.4	Nov-09	**1.03**	10.5	8.2	0			0.8	-0.6	30/09/2020
Greece	1.18	**1.19**	1.04	Sep-00	**0.99**	-2.1	-6.5	0		1.18	-0.1	-1.9	31/08/2020
Pakistan	164	**158**	182	Sep-01	**0.96**	-5.0	-1.7	0		170	7.3	9.0	30/09/2020
Chile	799	**766**	950	Jun-03	**0.96**	-3.9	-0.9	0			0.3	3.1	30/09/2020
Russia	77.0	**71.6**	140	Jan-99	**0.93**	3.8	0.7	0		73.6	4.3	3.7	30/09/2020
Malaysia	4.15	**3.82**	5.75	Dec-98	**0.92**	3.3	-0.1	0			1.6	-1.4	31/08/2020
Colombia	3,840	**3,207**	4,410	Mar-03	**0.84**	-4.3	-4.7	-1			2.6	2.0	30/09/2020
South Africa	16.5	**13.7**	20.3	Dec-01	**0.83**	-3.0	0.2	-1	12.88	16	3.5	3.1	31/08/2020
Mexico	21.3	**17.6**	28.2	Mar-95	**0.83**	-0.2	-0.3	-1			4.5	4.0	30/09/2020
Argentina**	77.1	**58.5**	129	Jun-02	**0.76**	-0.8	na	0			77.9	35.3	31/08/2020
Brazil	5.60	**4.07**	7.81	Oct-02	**0.73**	-2.7	-1.8	-1			3.0	2.4	31/08/2020
Turkey	7.93	**5.16**	7.62	Sep-18	**0.65**	1.1	0.4	-1		6.5	12.8	11.8	30/09/2020

Note: Government bonds/bills except: Argentina (implied forward), Qatar, Taiwan, UAE (Interbank rates), Saudi Arabia (swap rate)
* Yvonne Mhango, Renaissance Capital's Sub-Saharan Africa economist
**Argentina's inflation data was unreliable for 2007-2015 – we have constructed an REER series using 'shadow' inflation data

Source: Bruegel, Renaissance Capital

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	289				**9**	

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