

# Turkey as an Asset Class

## Turkish Economy: Attracting Foreign Investments - TABCON 2006

Presented by

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# Hot Money

- Why should we care about portfolio investors?
  - They determine the prices (of, well, everything)
  - They determine liquidity
- Who cares about prices and liquidity?
  - Potential real investors and innovators (exit strategies)
  - Companies (for raising more money)
  - Importers
  - Exporters
  - Governments (like “**stable**” prices for long-term growth)
  - Investors (also like stable prices but can cause instability precisely because of this risk aversion)



# Financial Times –May 18

## **Turkey's correction fails to surprise the man in the street...**

There can be few countries so literate about foreign exchange rates as Turkey. The fortunes of the lira and the imminent arrival of the next financial crisis are staples of dinner party conversation and newspaper headlines. Stop a person on the street and request the exchange rate, and one is certain to get it, down to the nearest cent.

For the past few days Turks have watched with a certain knowing fascination as the currency, which many people on the street believe to be considerably overvalued, tumbled against the euro and the US dollar, and said: "Told you so." ...



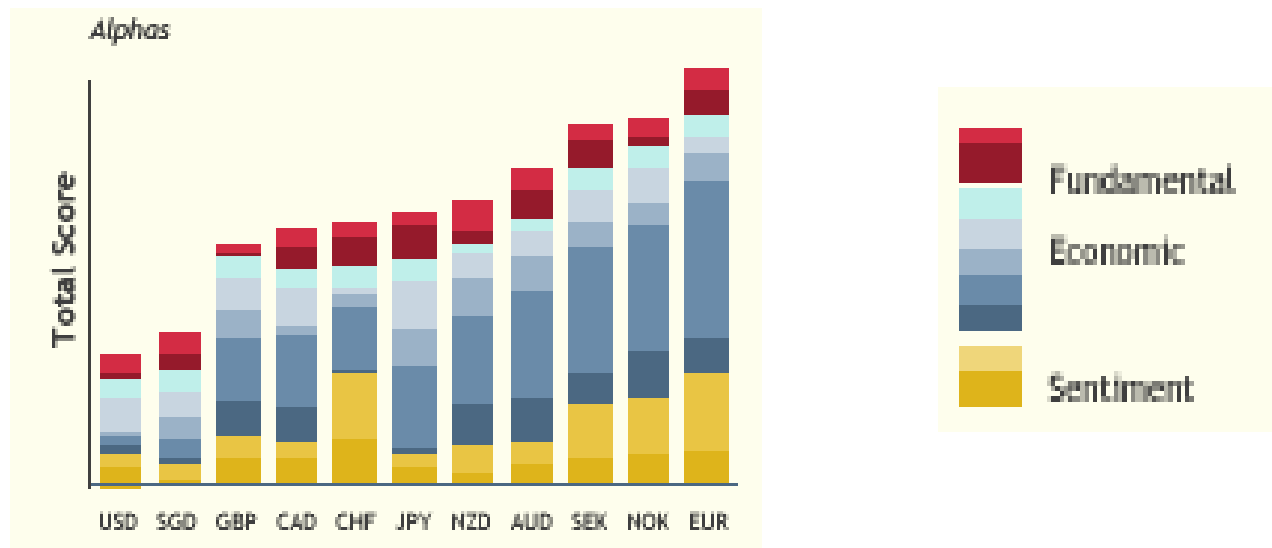
# Framework for Forecasting Currency Returns

- Fundamental Value (Equilibrium Exchange Rates)
  - Commodities prices
  - Long-term growth
- Economic Environment (Business Cycles)
  - Real activity
  - Interest rates
  - Inflation
  - Monetary Policy
- Sentiment (Market Expectations)
  - Short-term capital inflows
  - Intervention policy



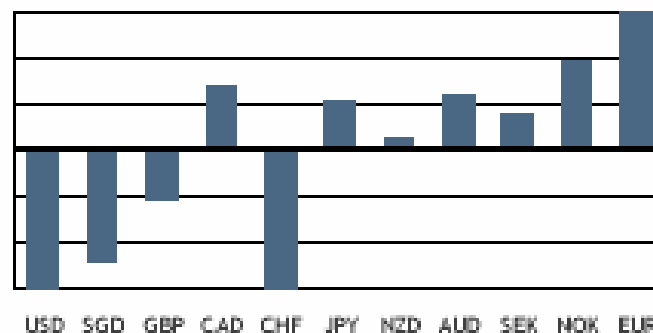


# Portfolio Construction—A BGI Example



Transaction cost model

Risk model



# Fundamental Signals in the “Alpha” Model

## Positive

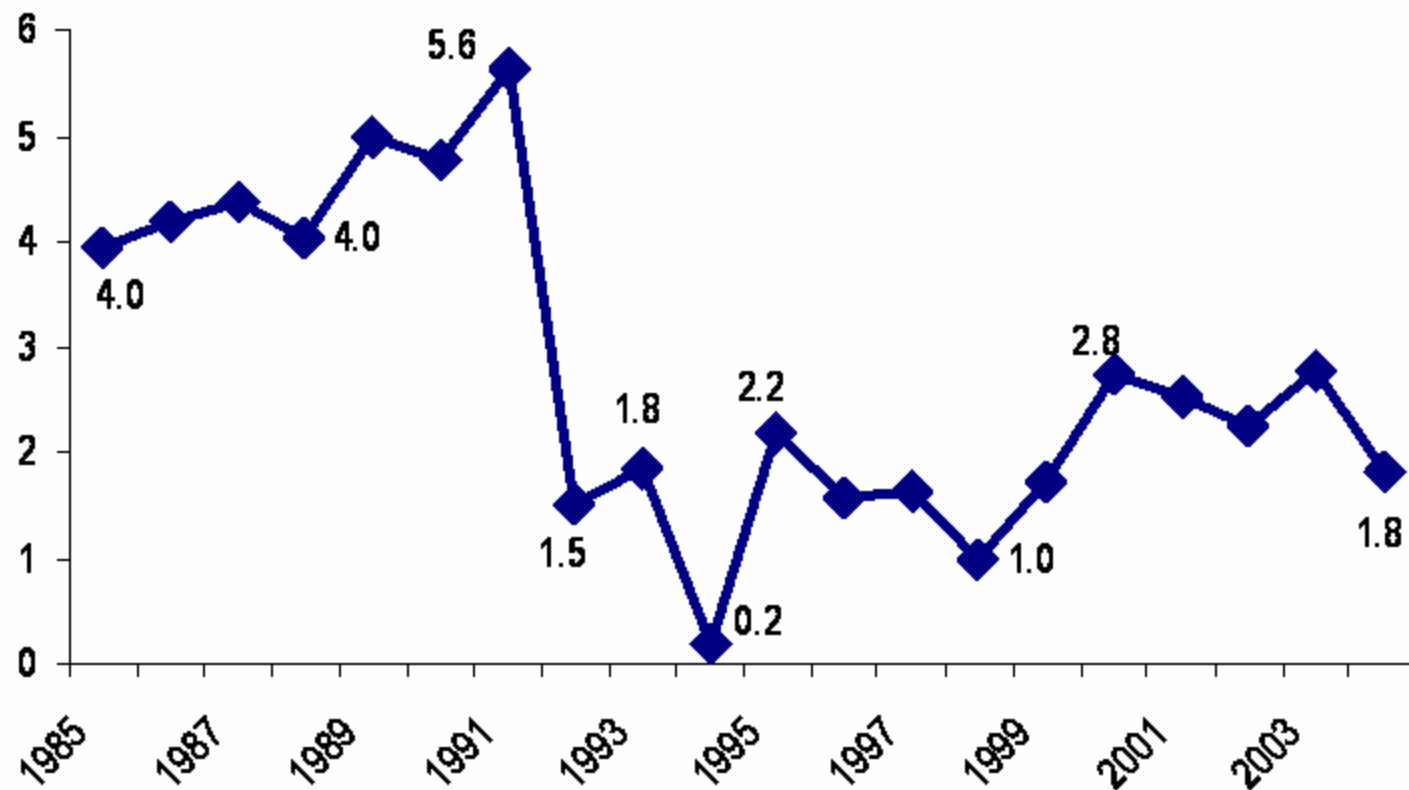
- GDP growth of about 7.7% during 2002-2005.
- Single digit inflation, lowest since 1960s.
- Budget deficit fell from 17% of GDP in 01 to 2% in 05.
- Debt/GDP around 70% down from 100% in 2001.
- Increasing FDI

## Negative

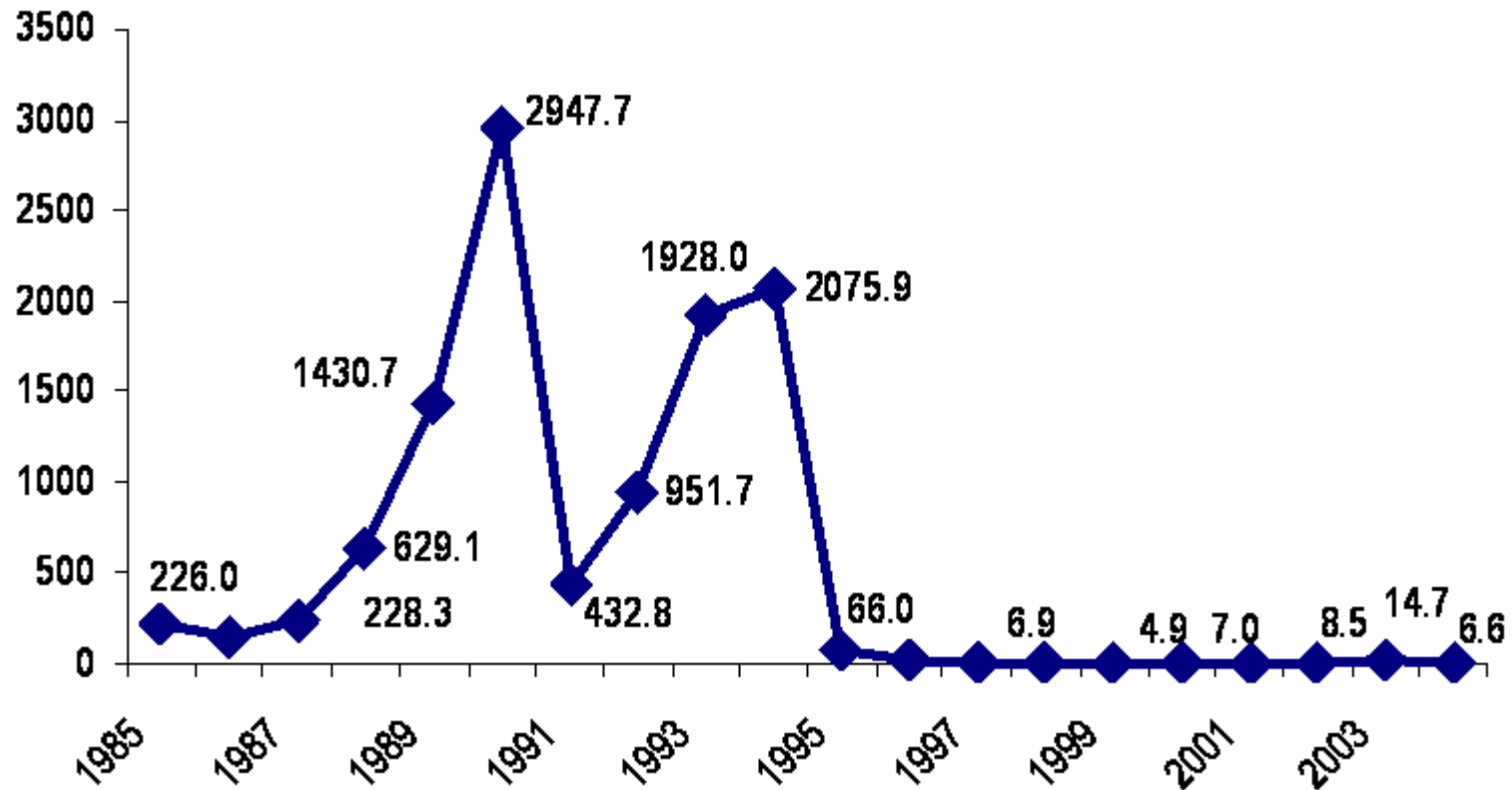
- Hot money > FDI
- Increasing current account and trade deficit
- 10+% unemployment since 2001.
- GDP growth > Industrial output growth (exporters getting hit—still?)
- Possibly overvalued currency (still?).



# Inflation Rate in Canada

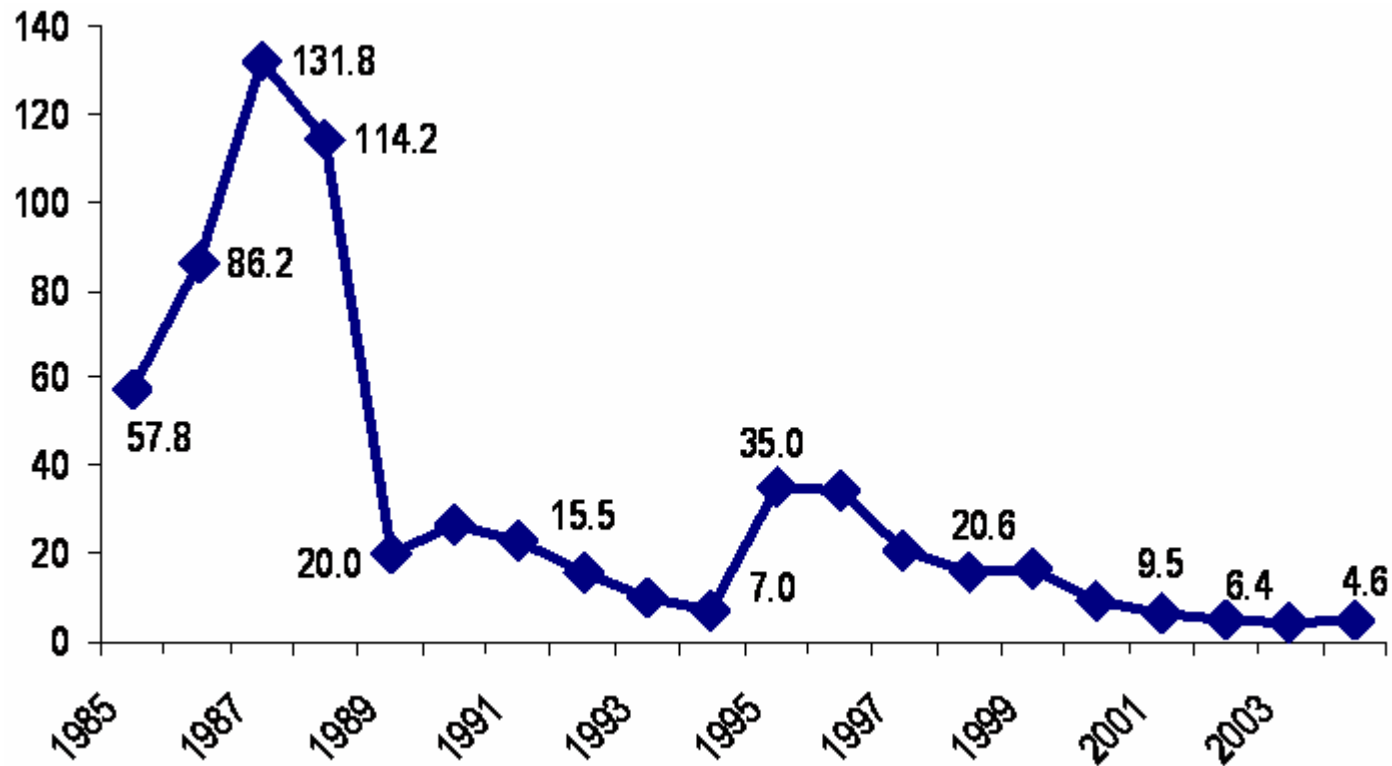


# Inflation Rate in Brazil





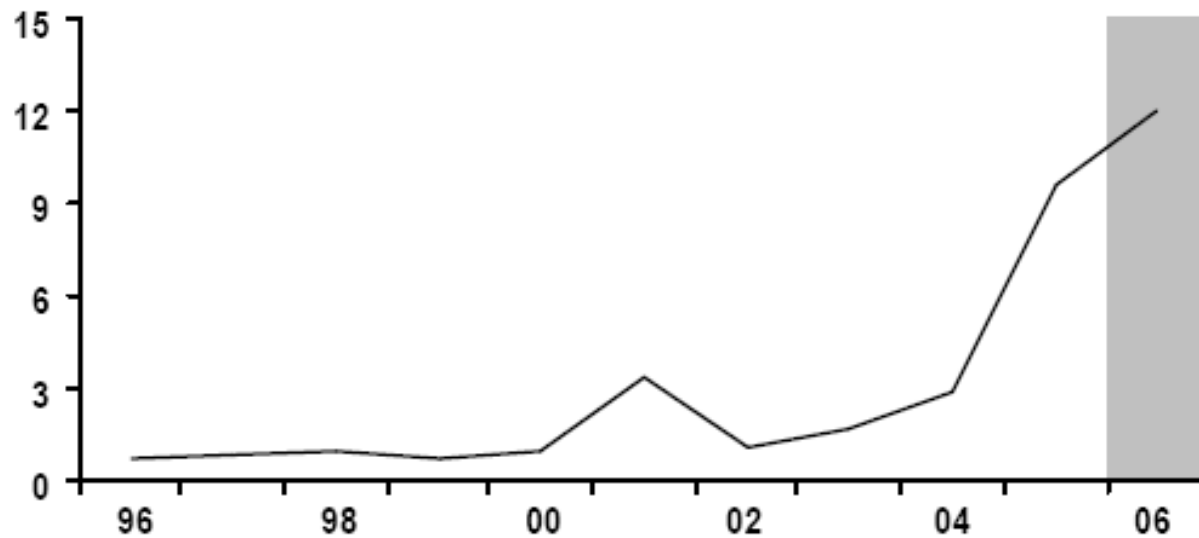
# Inflation rate in Mexico



# Real Investment is Increasing, but...

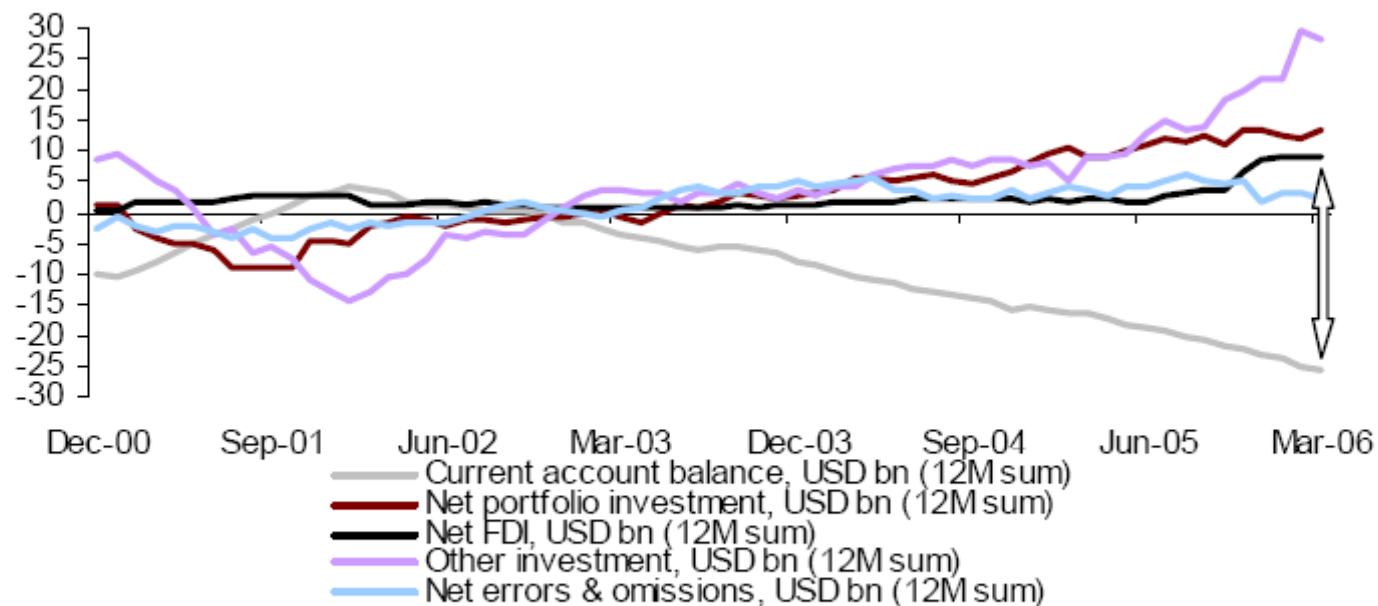
## FDI inflow to Turkey

US\$ billion



# ..does it Finance the Current Account Deficit?

**Basic balance\* stays firmly in the black**



Source: Datastream, Calyon-CMR. \*basic balance: defined as net FDI + current account deficit

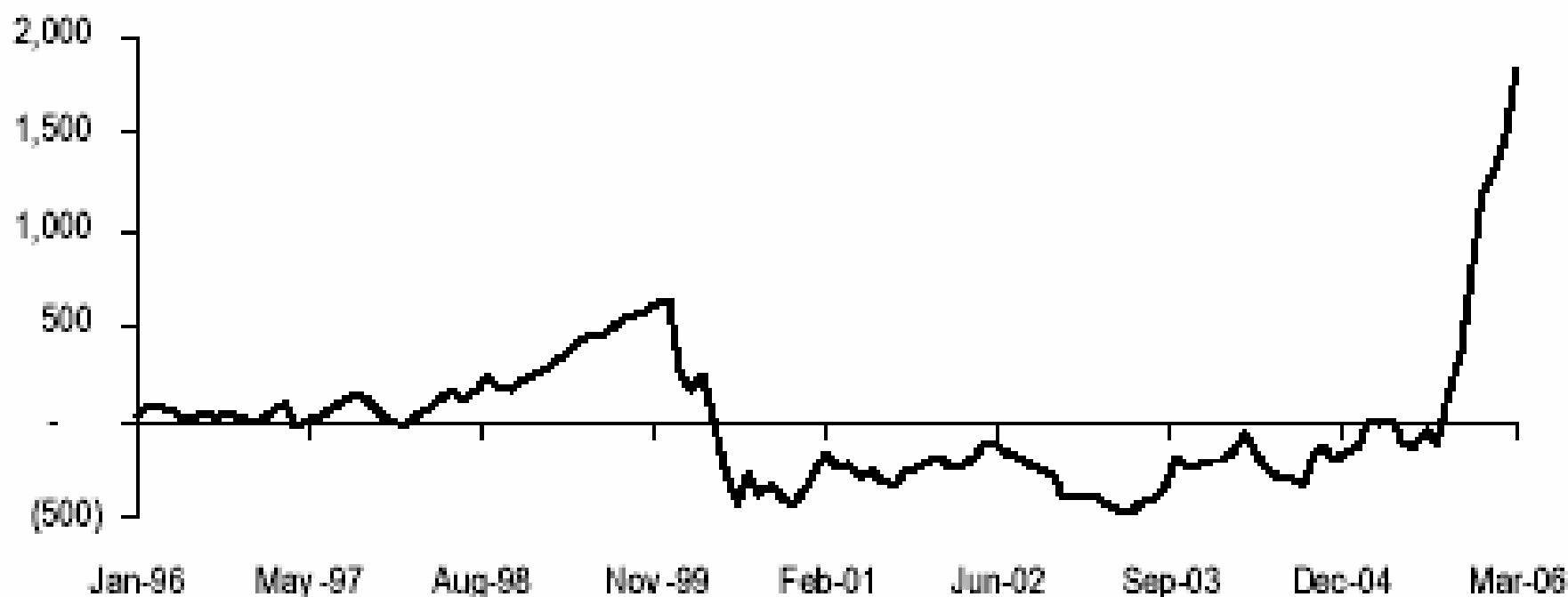


# Herd Instinct

Key Emerging Markets & Developed Asia Fund Flow Weekly, 27 Apr - 3 May 2006

## Monthly cumulative net foreign investment into the Turkey stock market

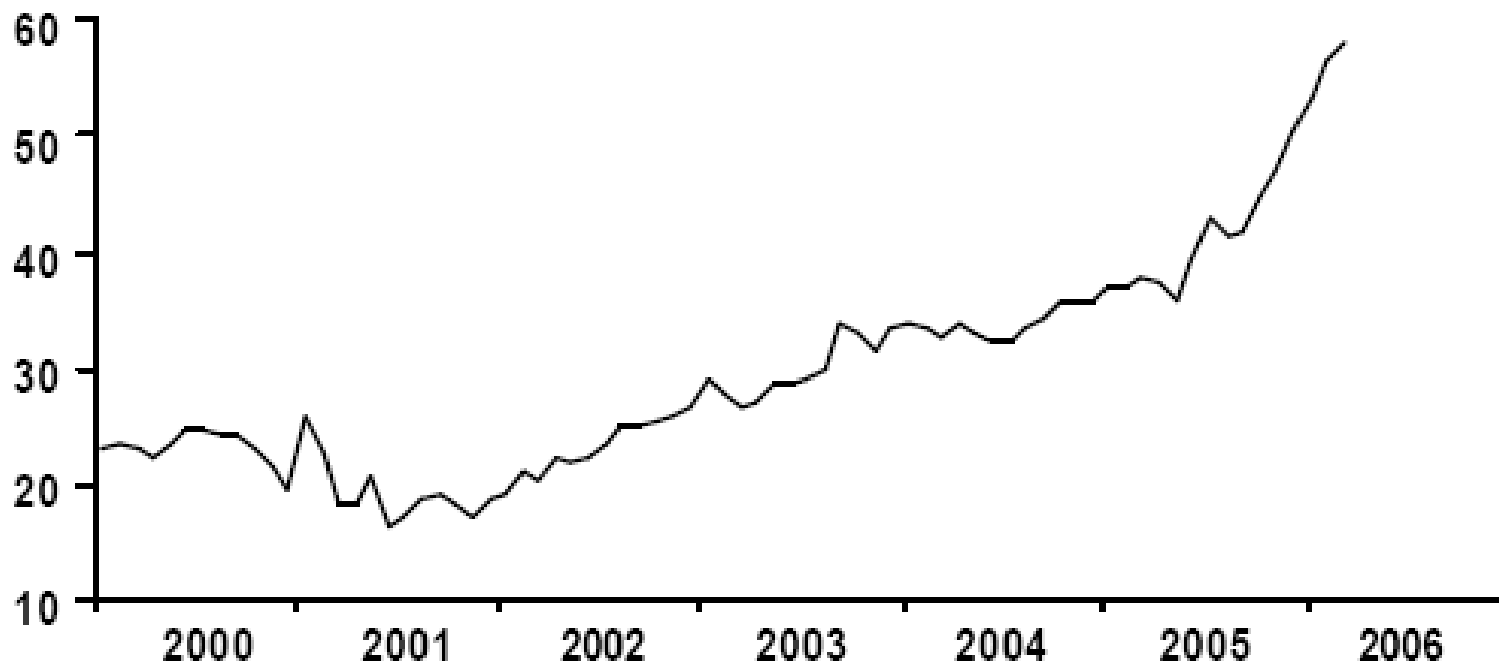
US\$, mils



# Towards more stability

## CBRT foreign currency reserves

US\$ billion





# Current Sentiment vs. Expectations

- MS: “Turkey’s progress is a result of prudent policies and structural reforms, not just about a favourable liquidity cycle. As long as the government remains on a cautious path, the Turkish economy will weather the global storm.”
- MS: “..Buy bonds, wear diamonds a la Turca.. Investors are unlikely to get another chance to buy Turkish bonds at 15%...”
- JPM: “.. medium-term disinflation outlook remains well anchored.. Turkey remains vulnerable to shifts in market sentiment due to its significant debt refinancing needs and CAD...”
- LB: “..we expect inflation to drop back in May...”
- ML:” We are downgrading Turkish external debt to underweight from neutral in our model portfolio.” (good call, came May 10)



# Where to next

- CB should intervene to keep TRY from overvaluation (in non-crisis times).
- Should increase FX reserves for the rainy day with minimal impact on TRY.
- May 16 announcement to stop FX purchases was consistent with the above two.
- The smoother the currency adjustment during the process of disinflation, the less likely to observe a sharp devaluation that could overshoot its equilibrium value toward undervaluation, thus triggering the inflation again.
- Economy will keep walking a tight rope until TRY, inflation and CA deficit converge to a sustainable level. On the real side, this requires structural changes like implementing the social security reform (just legislated) and improving the energy policy.
- Better fundamentals can minimize volatility only up to a certain point, as long as the (**liberal**) capital markets (**economy**) are small.

→ **The solution?**



# Appendix – Figures and Tables



# Stock Market

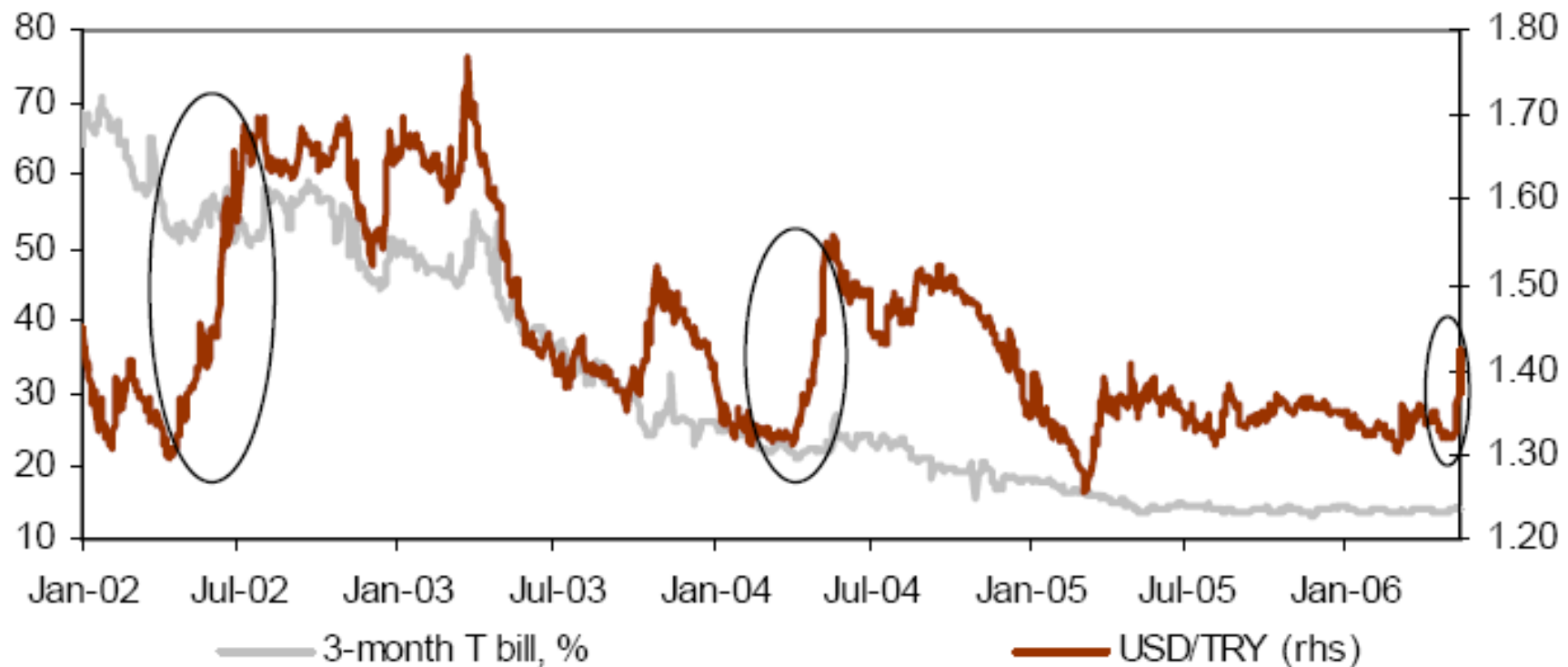
## Capitalization Data (\$mn)

Total Market Capitalization	131,460
Total Free Float Market Capitalization	41,723
Coverage Market Cap / Total Market Cap(%)	78.2

## Daily Close of ISE-100 (US\$)

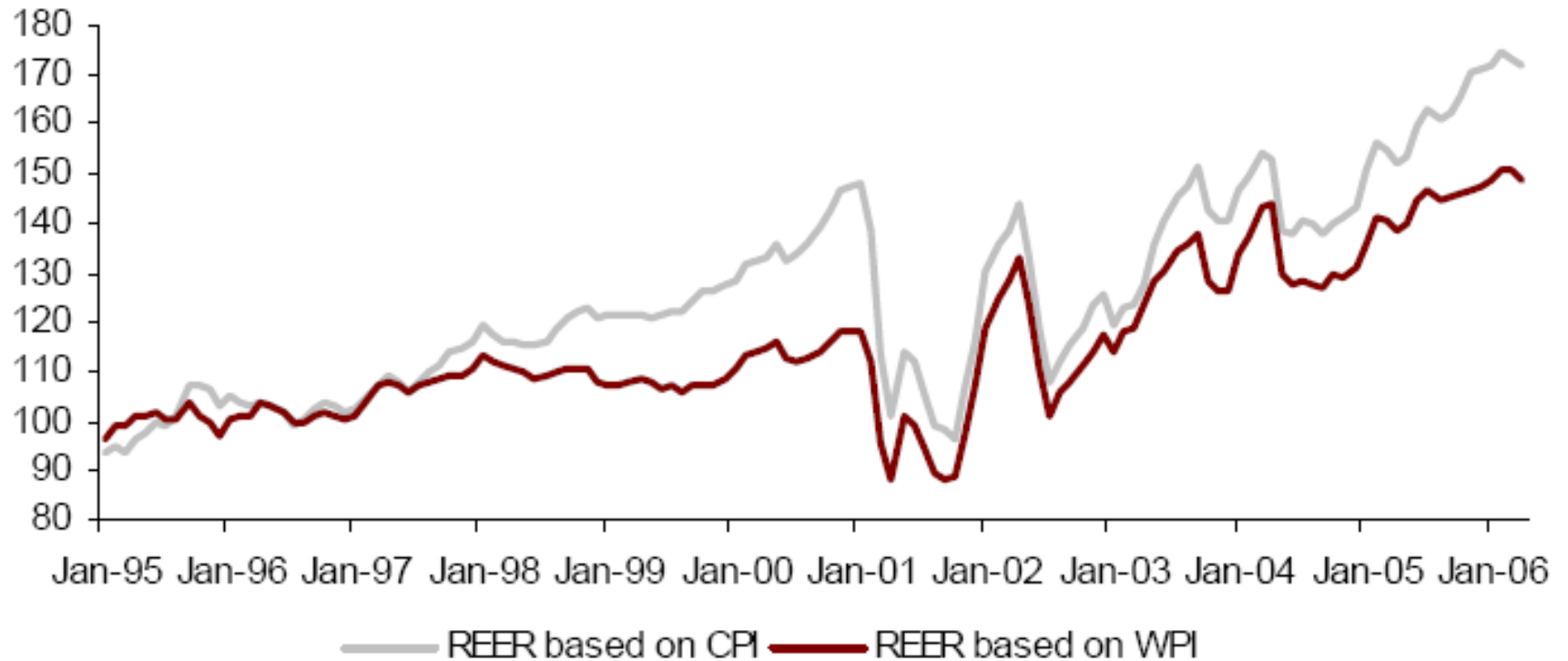


# Nominal Exchange Rate and Interest Rates





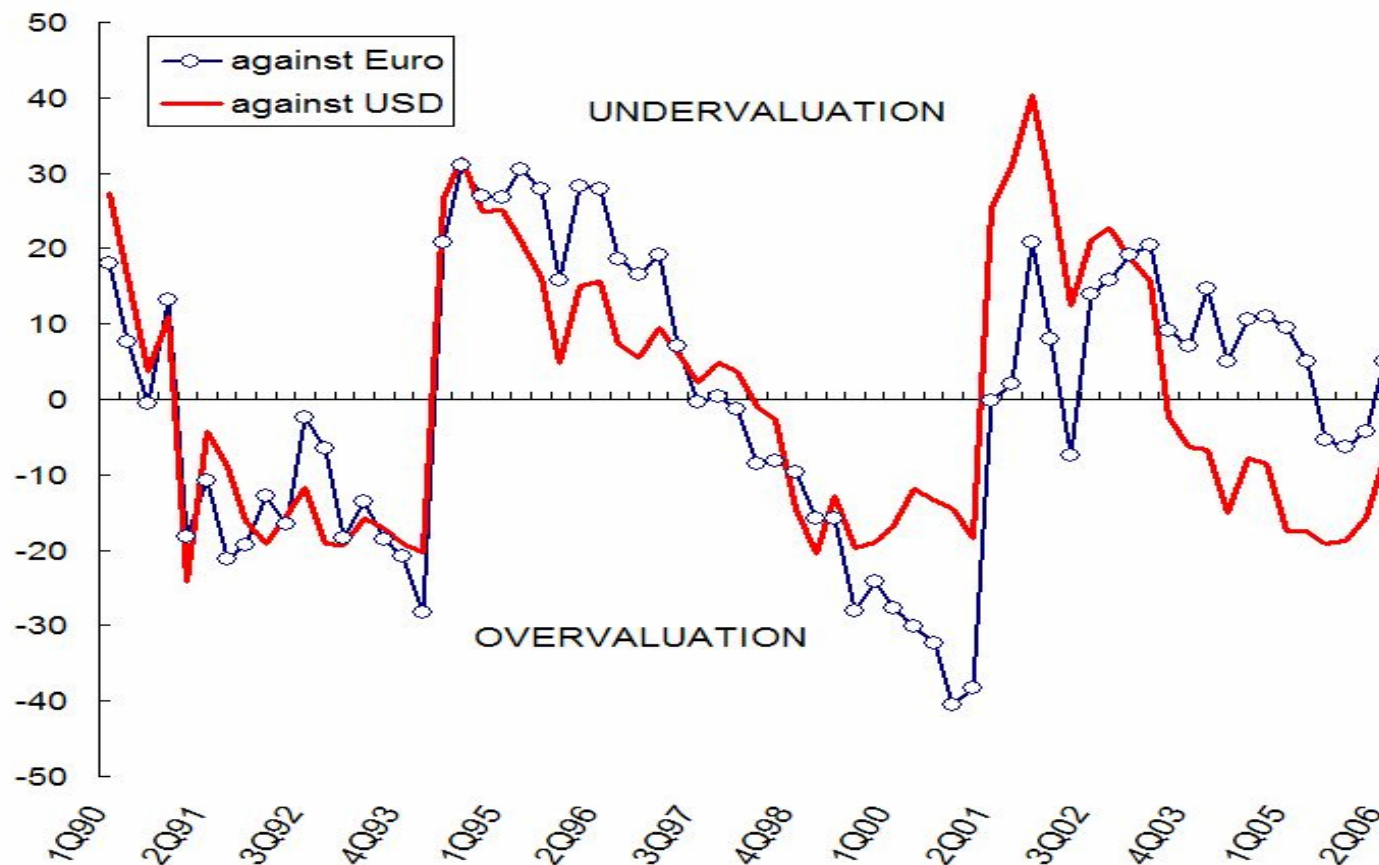
# Real Exchange Rate



# MS model – Currency Correction

Exchange Rate Misalignment, 1990-2006

Percent misalignment from PPP-implied fair value (based on unit labour costs)

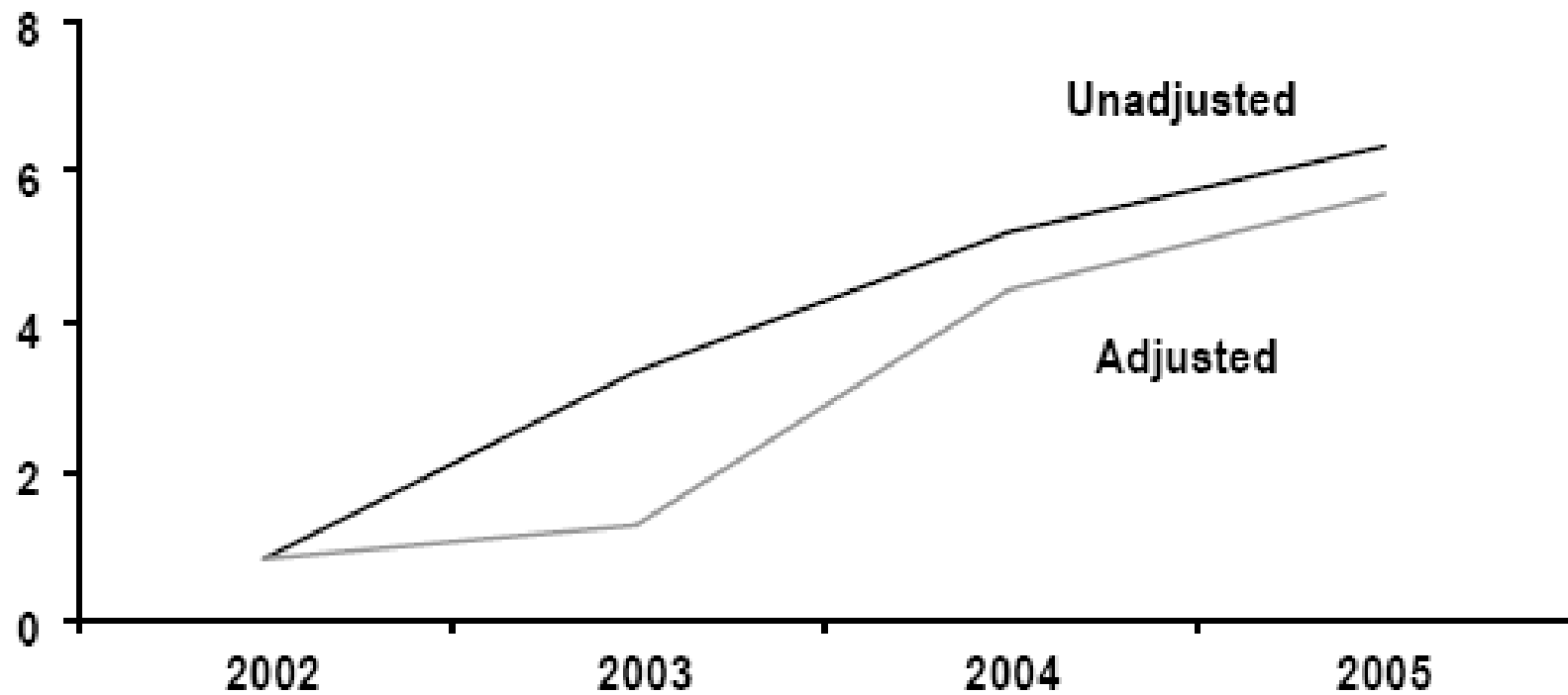


Source: Morgan Stanley Research

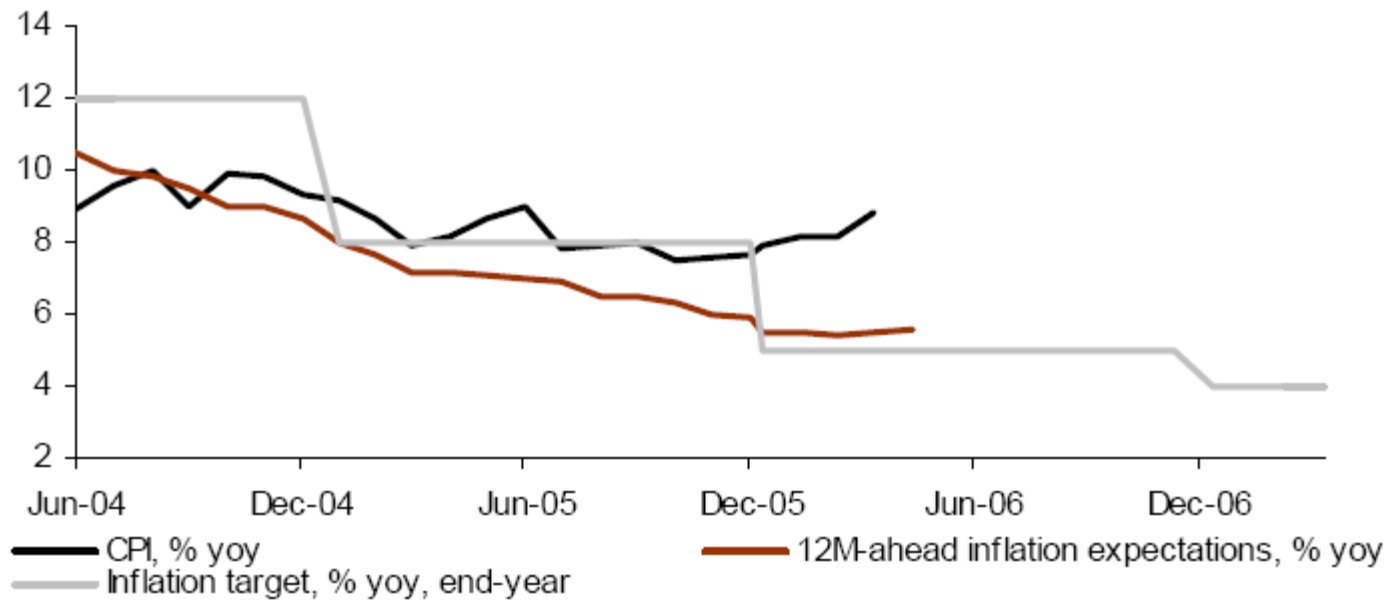
# Current Account Deficit

## Current account deficit

% of GDP



# Realized and Target Inflation Rates



# Supply Side

## Productivity gains outpace real wage increases

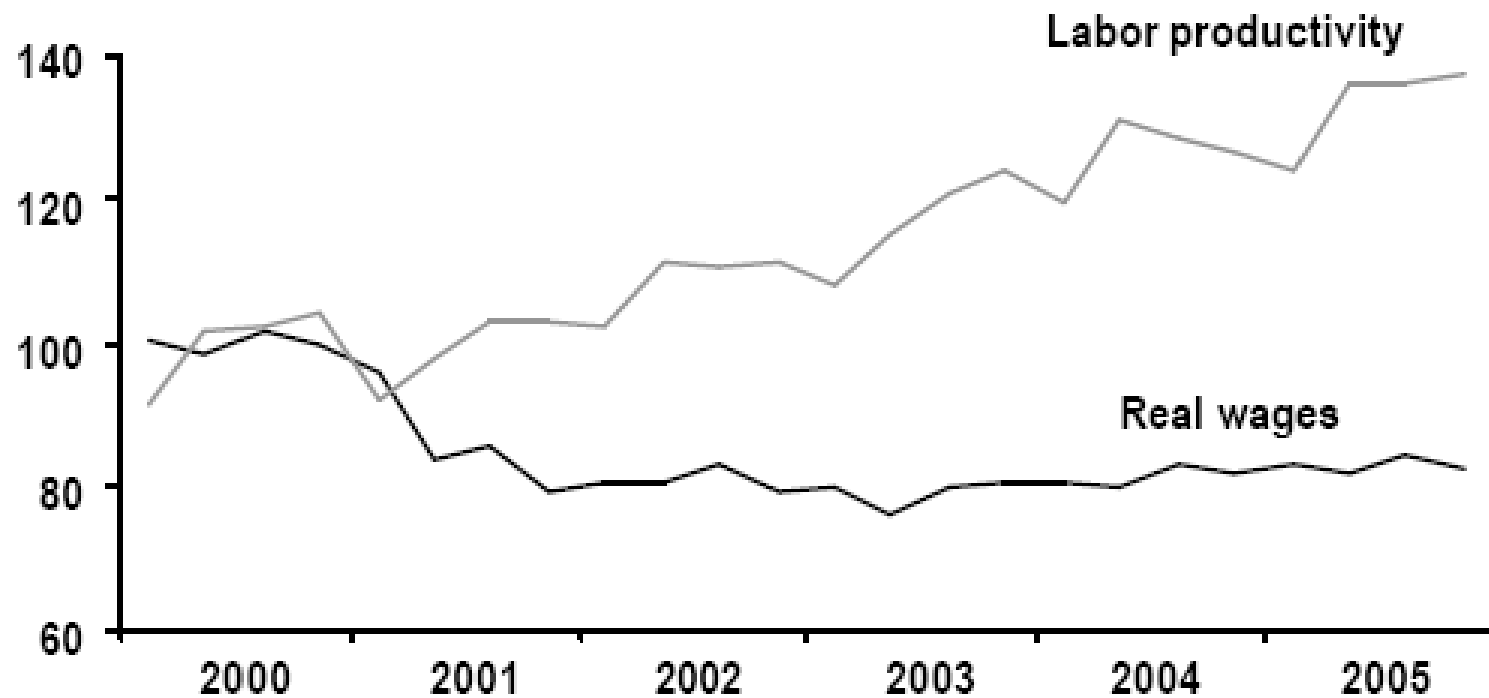




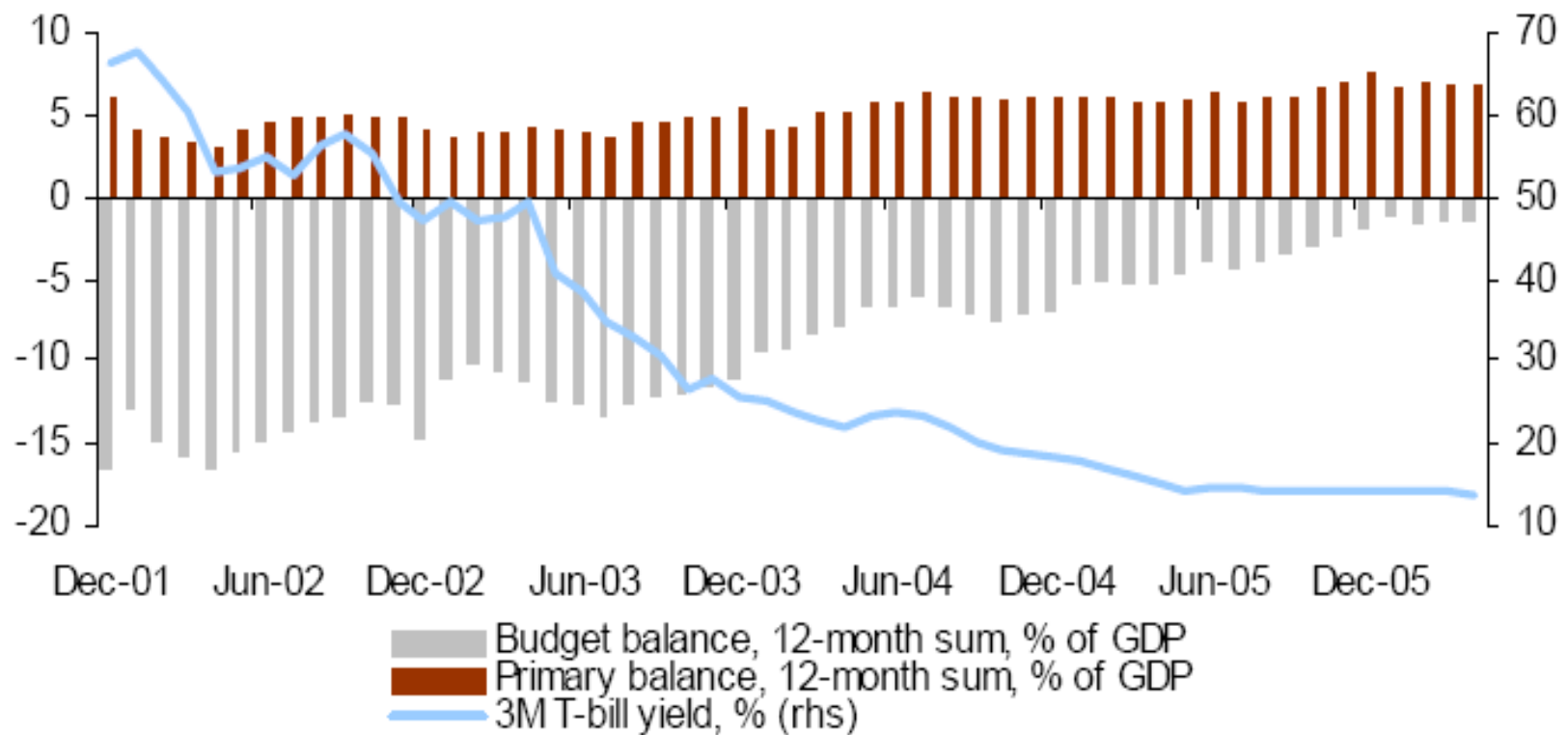
# Productivity

## Real wages and labor productivity in manufacturing

2000=100



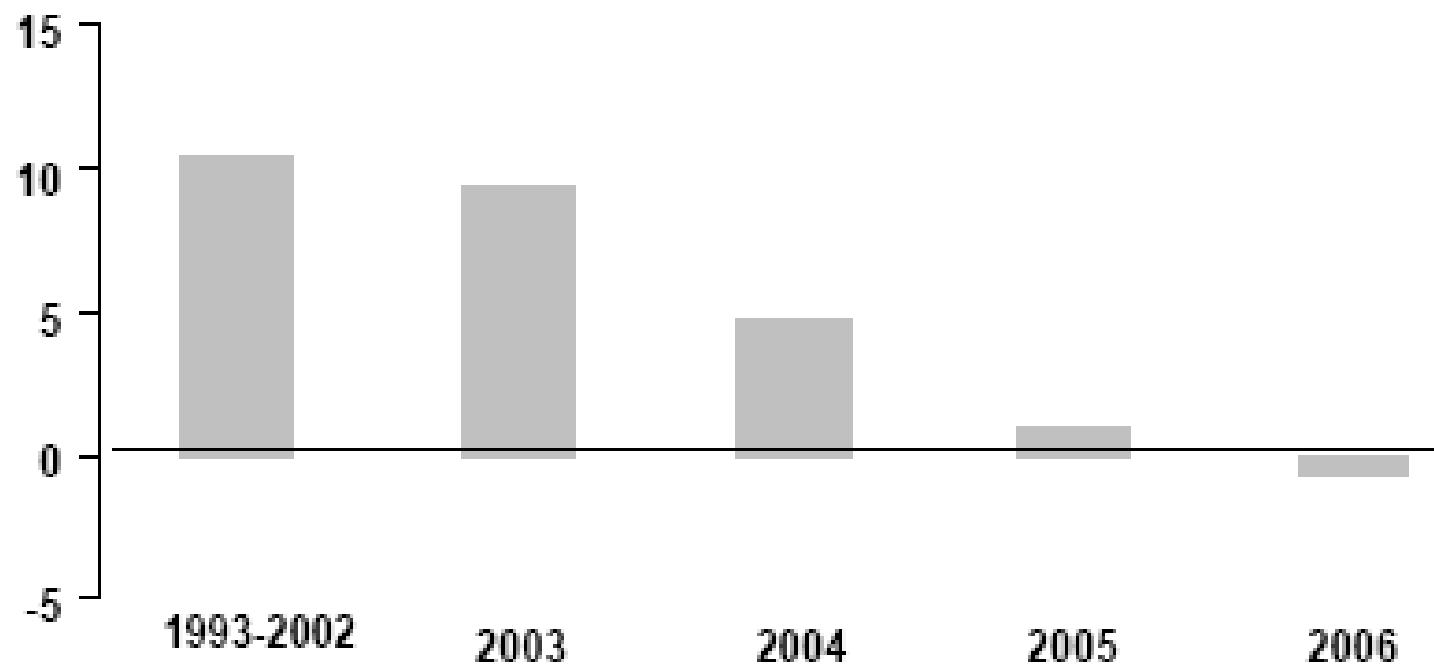
# Budget Deficit



# Budget Deficit

## Public sector borrowing requirement

% of GDP



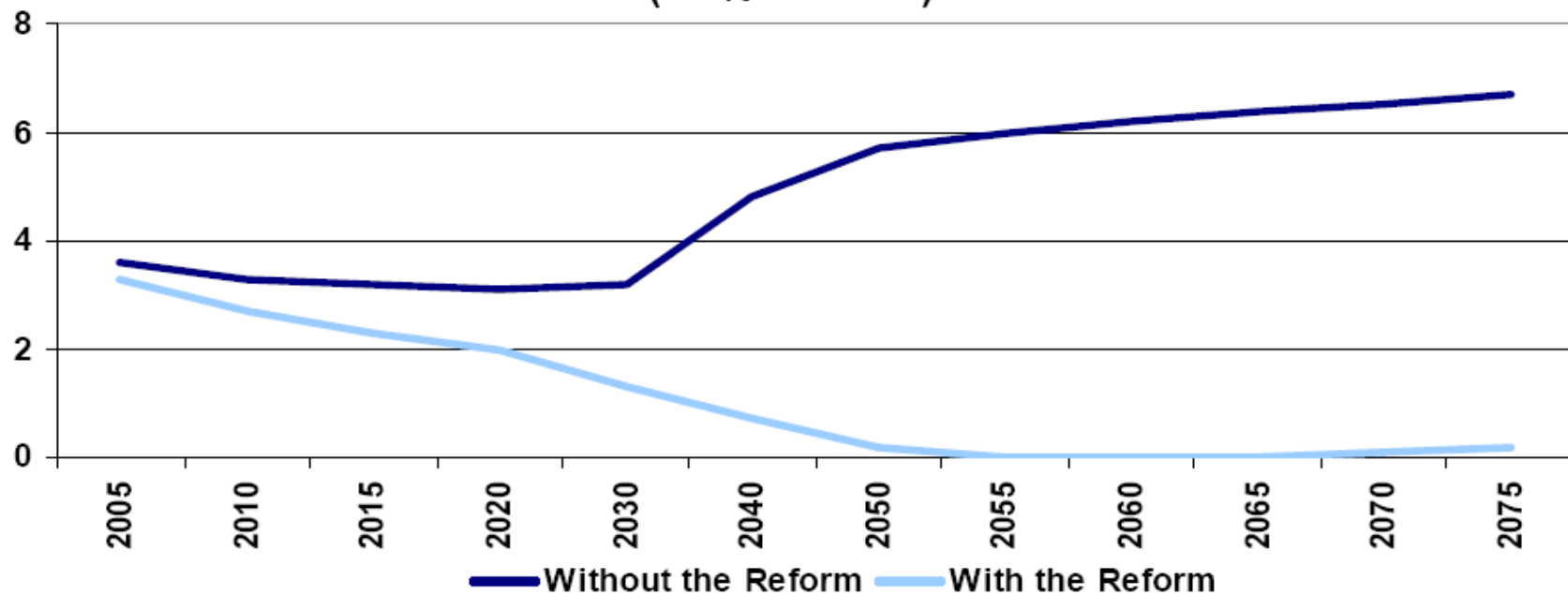
# Key Indicators

	<b>GDP</b>	<b>Growth</b>	<b>GDP/Capita</b>	<b>PPP adjusted</b>		<b>Debt</b>	<b>Debt/GDP</b>
2001	146	-9.5	2123	6131		123.6	100.9
2002	181	7.9	2598	6519		148.5	88.3
2003	239	5.9	3383	6762		202.7	79.3
2004	299	9.9	4172	7561		235.8	73.8
2005	361	7.6	5008	8141		247.1	68.2
2006E	381	5	5216	9017	(March)	249.1	61.9



# Social Security Problem

Comparative Projection of the Pension System Deficit  
(as % of GDP)



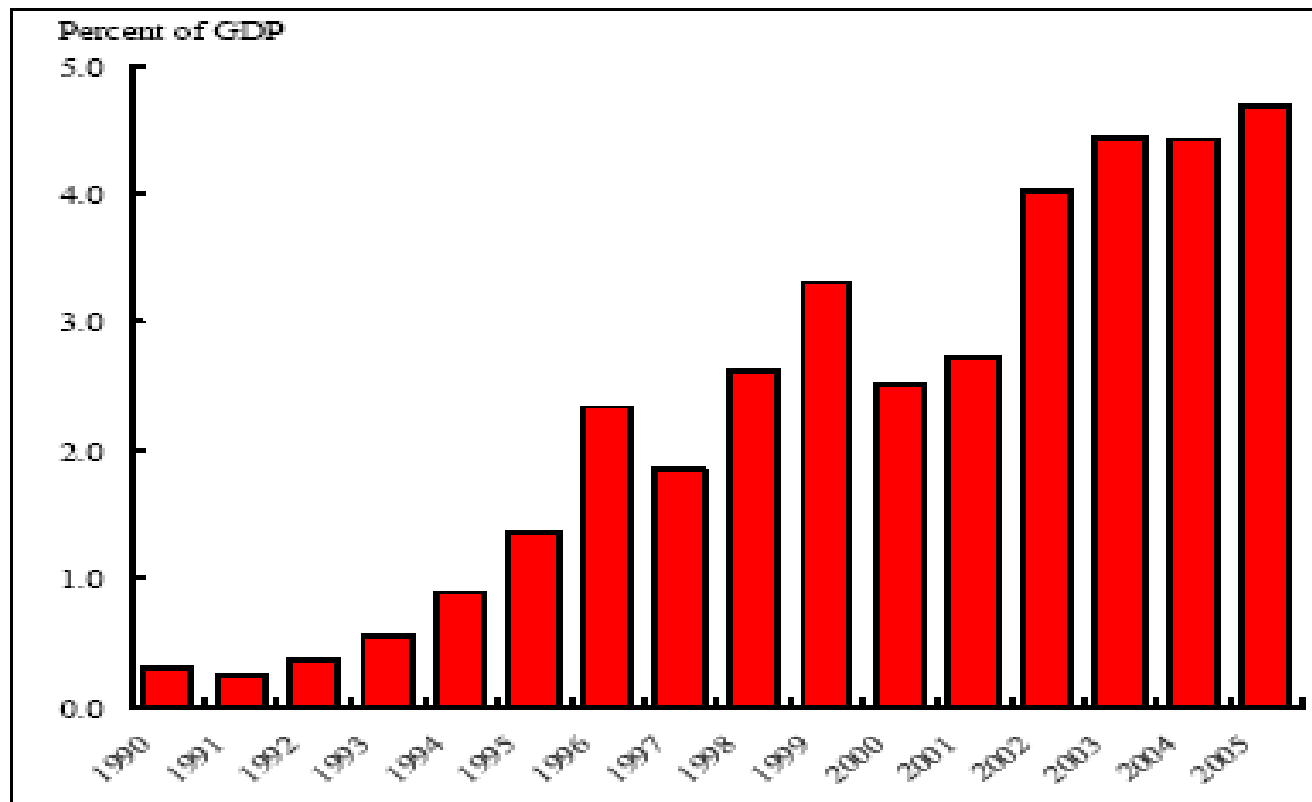
\*Source: Ministry of Labour





# How did we get here?

## Social Security Deficit, 1990-2005



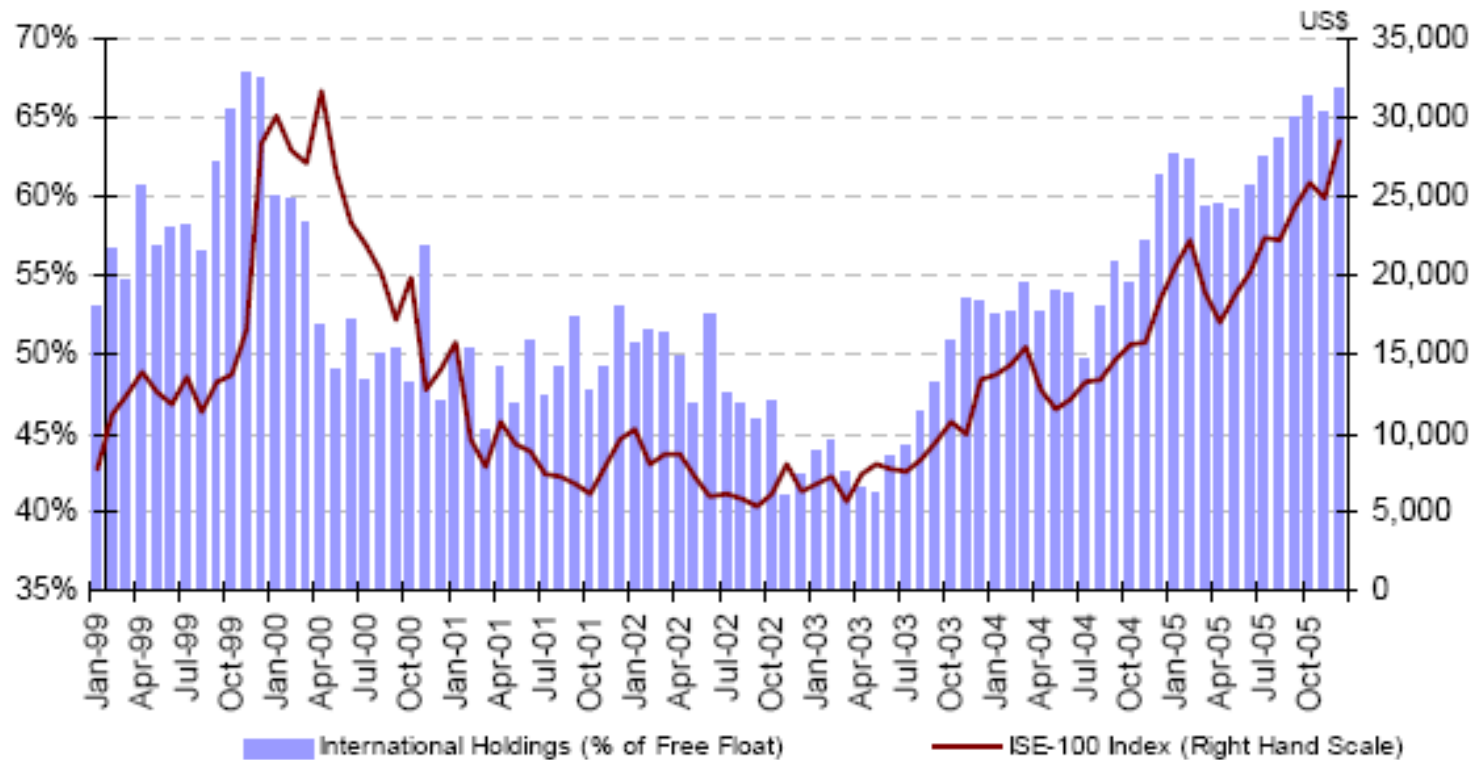
Source: Ministry of Finance, Morgan Stanley Research



# Who owns the Turkish stocks?

## Flow Analysis

Int'l Holdings (% of Free Float) vs. ISE-100

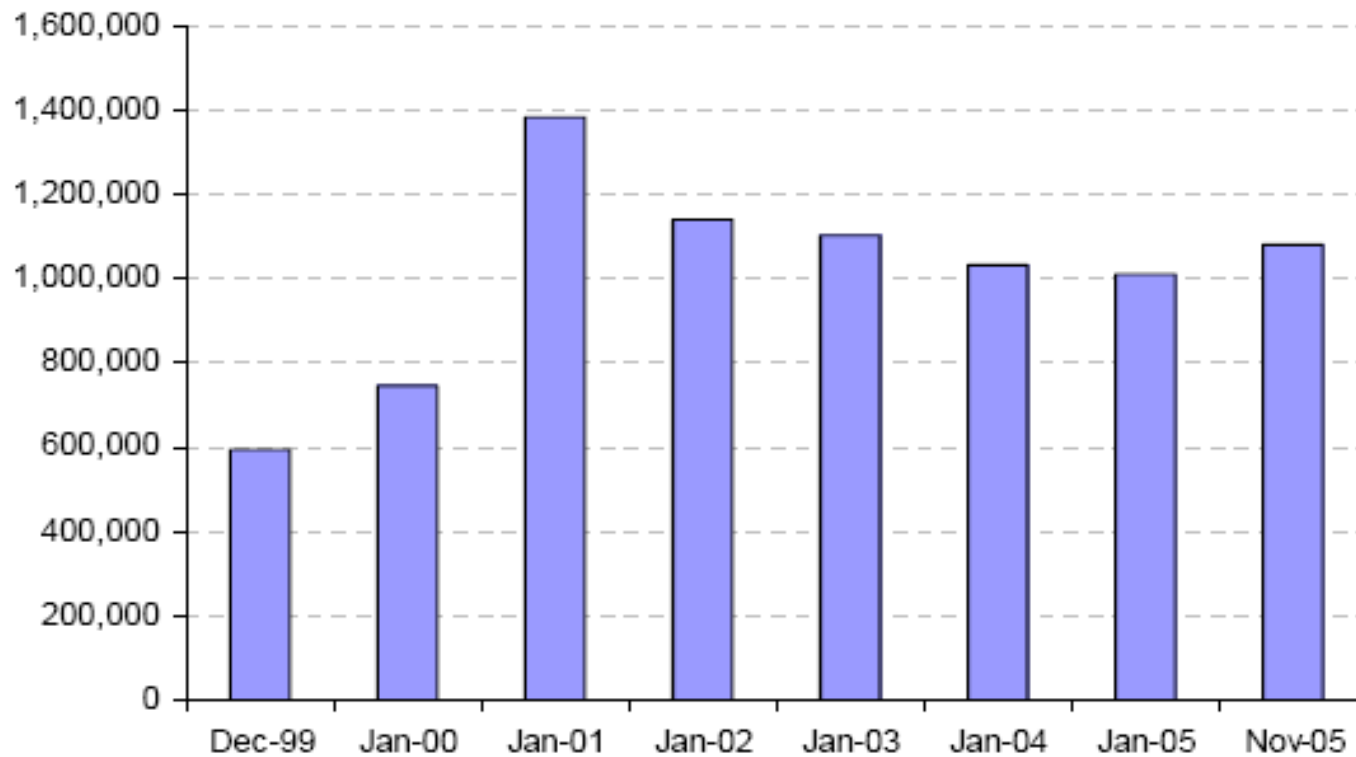


Source: EFG Istanbul Research & the ISE



# Investor Breadth

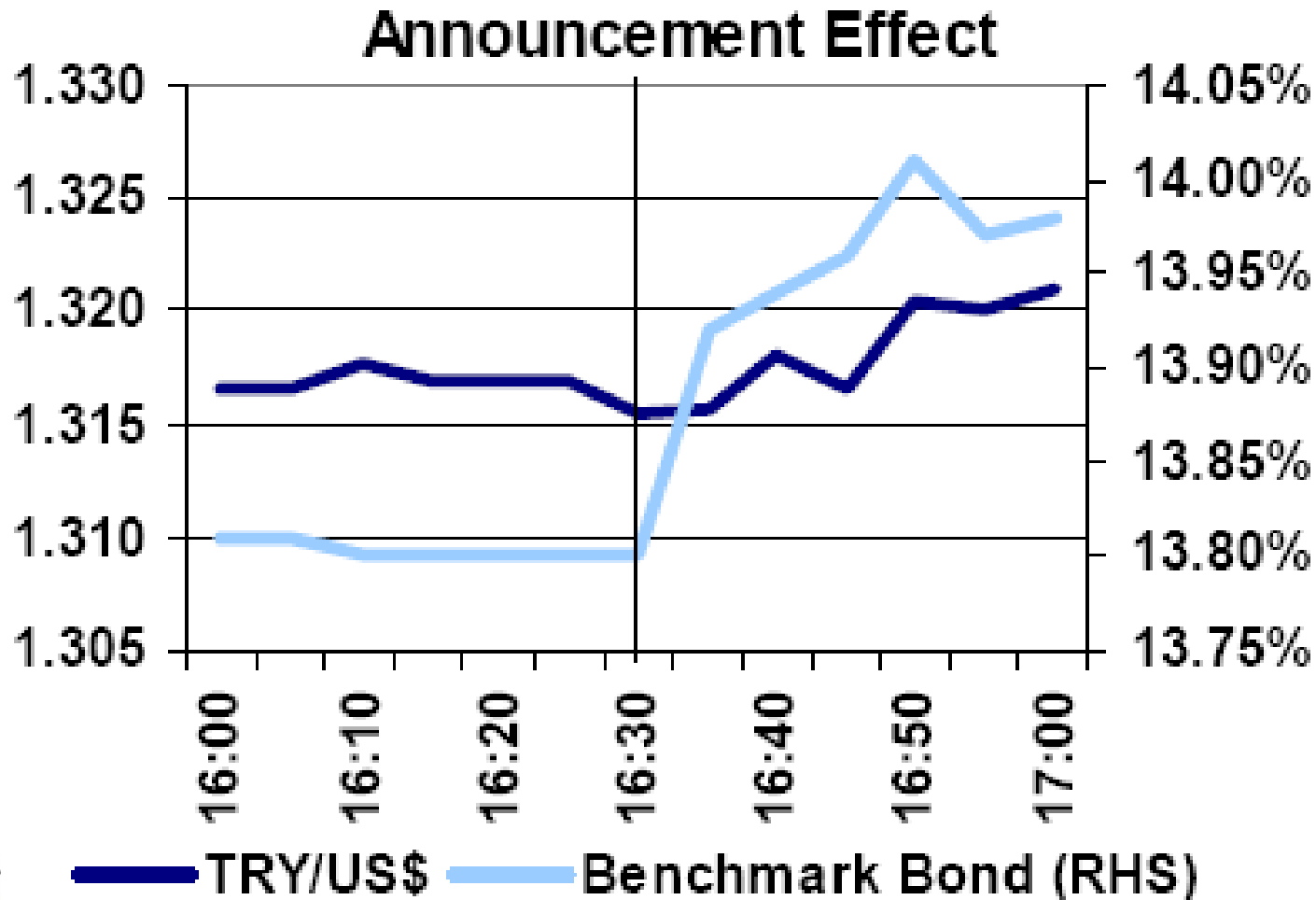
# of Investors Holding Turkish Equities



Source: ISE Settlement & Custody Bank



Yes, investors are watching...April inflation @8.8%



## Net public debt

% of GNP

