Food prices surprise on the downside in March

Annual inflation below 4% in March…

Consumer prices rose 0.42% in March over February, less than the market consensus (0.77%) and our in-house forecast (0.75%). Hence, annual inflation declined further in March to 3.99% - the lowest since 1970 - from 4.16% in February. The 0.41% MoM decline in food group prices was behind the surprising inflation outcome, reducing the monthly headline by 0.1 points.

All of the nine core inflation indicators rose in March …

However, core inflation indicators do not provide a rosy picture as does headline inflation. In fact, all of the nine core inflation indicators rose in March over February. On the other hand, annual I index inflation, which is the most closely followed core inflation indicator by the CBRT, and excludes food, energy, alcoholic beverages, tobacco products and gold remained flat at 3.77% in March, declining a mere 1 bps over February.

Cost pressures from producer prices continued to mount in March…

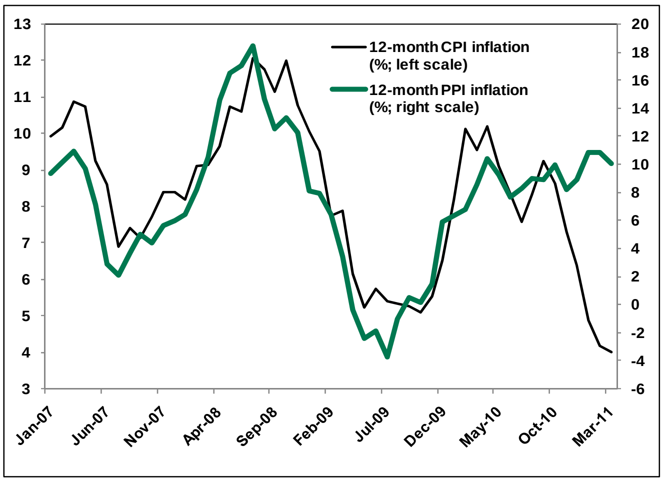
Meanwhile, cost pressures from producer prices continued to accumulate. In March, producer prices rose 1.22% MoM, following the consecutive high prints through December-February.

Despite the benign inflation print in March, we project CPI inflation to increase gradually and close the year at 7.6%, above the official target (5.5%) and the CBRT's forecast (5.9%) due to the lagged effects of exchange rate pass-through, higher oil prices and strong domestic demand. The expected increases in utility prices after the general elections are another factor in our forecast.

Summary Inflation Data: March 2011
(in percent)

	Monthly		12-month	
	Mar 11	Mar 10	Mar 11	Feb 11
CPI	**0.42**	**0.58**	**3.99**	**4.16**
Food and Beverages	-0.41	0.62	3.47	4.53
Tobacco and Liquor	0.03	0.01	-1.49	-1.51
Clothing and Footwear	0.77	0.69	5.43	5.35
Housing	0.38	0.20	4.57	4.38
Houseware	0.94	-0.45	6.11	4.66
Health	0.15	0.04	1.40	1.29
Transportation	1.57	0.73	6.91	6.03
Communication	0.34	3.14	-4.17	-1.50
Entertainment and Culture	0.46	0.69	-2.19	-1.97
Education	0.29	0.36	4.28	4.35
Hotels, Cafes and Restaurants	0.43	0.98	8.01	8.60
Misc. goods and services	1.17	0.70	7.86	7.36
PPI	**1.22**	**1.94**	**10.08**	**10.87**
Agriculture	0.68	2.79	10.54	12.86
Mining and Quarrying	2.62	-0.54	16.35	12.77
Manufacturing Industry	1.48	1.91	10.51	10.98
Electricity, Gas and Water	-0.36	1.11	3.80	5.33

Source: TURKSTAT



Source: Turkstat

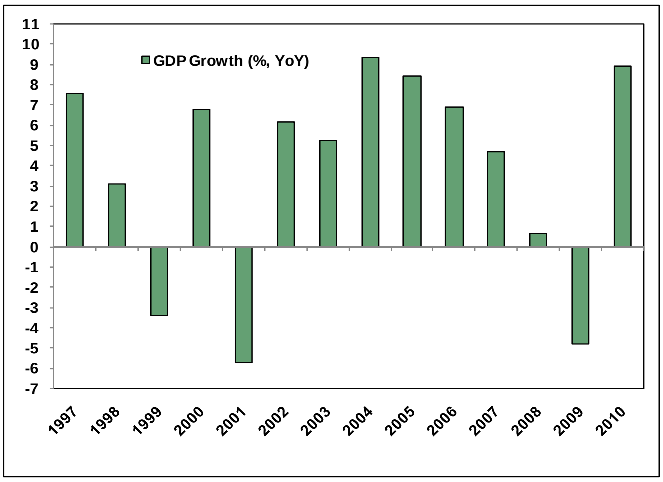
Very strong growth print in Q4

In real terms, economic output expanded by 9.2% YoY in the 4th quarter, above the market consensus (7.2%) and our in-house forecast (7.1%). On the other hand, the seasonally and working day adjusted series shows that the economy expanded 3.6% QoQ in Q4, which is a very strong figure after 1.2% in the third quarter. In fact, the WD and SA figures imply that the economy is heading toward overheating as the WD and SA GDP for the 4th quarter is a new record high.

Working day and seasonally adjusted GDP for the 4th quarter is a new record high…

Powerful domestic demand was behind the growth once again in the last quarter, contributing 15.4 points to the growth rate. Private consumption and investments rose 9% YoY and 49.5% YoY, respectively, almost in line with our forecasts. On the other hand, public expenditures and investments rose by 3.2% and 17.1% YoY respectively. Meanwhile, stock changes reduced GDP growth by 0.7 pp in the last quarter. On the other hand, net domestic demand erased 5.6 percentage points from Q4 growth as import growth outpaced that of exports.

In annual terms, the economy grew by 8.9% in 2010 after contracting 4.8% in 2009 (revised from -4.7%). It is the highest growth rate since 2004.



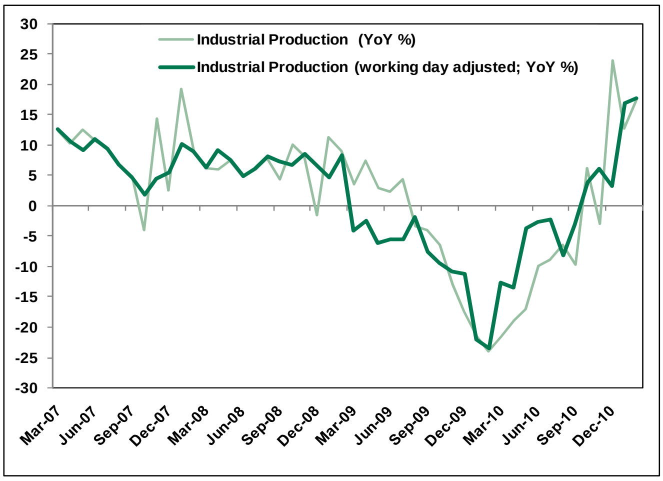
Source: Turkstat

IP below consensus in February, but supports strong growth in Q1

Industrial production (IP) rose 13.9% YoY in February, less than the 15.4% market consensus and our in-house forecast of 14.5%. On the other hand, working day and seasonally adjusted IP declined 1.7% MoM over January, but industrial production remained near all time highs in February. The decline came after the 0.5% MoM rise in January and 5.4% rise in December in WD and SA.

We forecast the economy to grow 5.7% in 2011…

Intermediate and capital goods production surged 16.7% and 28.9% YoY respectively, and provided strong evidence that high economic momentum continued in March and is likely to continue in the months to come. We forecast the economy to grow 5.7% in 2011, with the assumption that it will slow down slightly in WD and SA terms in the second half on the back of the CBRT's contractionary measures against a record current account deficit.



Source: Turkstat

Seasonally adjusted unemployment rate at its lowest since June 2008

We expect the SA unemployment rate to decline further in the months after January, but at a limited pace...

In January, the unemployment rate declined 2.6 percentage points over a year ago to 11.9%. While it increased from 11.4% in December, the increase is fully due to the seasonal factors in certain sectors such as agriculture and construction. In fact, TurkStat's seasonally adjusted figures indicate a 0.3 point improvement in the unemployment rate in January over December. The SA unemployment rate declined further to 10.6% in January, the lowest level since June 2008.

We expect the SA unemployment rate to decline further in the months after January, but with a limited pace, as the CBRT's reserve requirement hikes will likely decrease the momentum of production, though in a limited degree.

The return of net errors and omissions?

12-month rolling current account deficit at a new record in February...

The current account deficit (CAD) for February came in at USD 6.1bn, in line with our in-house forecast (USD 6.1bn) and the market consensus (USD 6.2bn). The figure compares unfavorably with the USD 2.7bn recorded in February 2010.

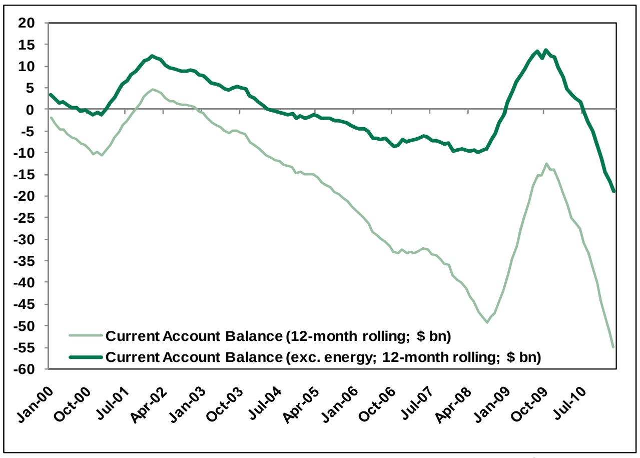
With the inclusion of February figures, the 12-month rolling CAD rose to a new record of USD 54.8bn from USD 51.4bn in January. On the other hand, the year-to-date CAD more than doubled over a year ago, to USD 12.1bn.

While the current account came in as expected, the financing side also deserves attention. The economy saw USD 6.5bn inflows in February. While the net FDI in February was weak at USD 0.4bn, portfolio investments saw a USD 1.5bn net inflow. On the other hand, while non-bank sectors brought USD 6bn deposits back into the country in February, banks sent USD 2.4bn deposits to their correspondent branches abroad and foreign banks withdrew USD 2.3bn of their deposits from Turkey. We think that the inflows and outflows by the banks are related. It may be due to account relocation by the non-bank sectors on the back of the events in the MENA region.

USD 3.3bn inflow under "net errors and omissions" in February particularly striking...

Another particularly striking figure is the USD 3.3bn inflow under "net errors and omissions" after the USD 2.2bn seen in January, which we had previously associated with the turmoil in the MENA region. The continuation of this trend will be important for the future of USD/TRY in the months to come.

The recent figures prove that the CBRT's measures have yet to slow down the widening in the current account deficit, and the fragility of financing due to the weight of short-term inflows.



Source: CBRT

Fiscal balances strong in Q1, but primary expenditures surged in March

First quarter figures shine compared to Q1 last year...

The central government budget posted a deficit of TRY 6.1bn and a primary deficit of TRY 2.1bn in March, slightly unfavorable compared to the TRY 5.9bn budget deficit and TRY 1.6bn primary deficit recorded in March 2010.

In March, revenues rose 18.2% YoY to TRY 20.7bn, whereas primary expenditures surged 19.3% YoY to TRY 22.8bn, which is the negative side of the budget as annual inflation is around 4%. The surge was primarily on the back of the TRY 2.7bn rise in current transfers before the general elections in June.

Meanwhile, the first quarter figures are shining compared to Q1 last year. The budget only registered a deficit of TRY 4.1bn (Q1 2010: TRY 11.3bn), whereas the primary balance posted a surplus of TRY 9.8bn compared to TRY 3.7bn Q1 last year.

While the surge in primary expenditures in March is worth highlighting, we will wait for the April figures to decide whether it is a trend before the general elections.

Central Government Budget: 2010-2011
(in billion TL)

	Q1		Real growth (%)
	2011	2010	
Central Government Revenues	68.7	57.0	15.9
o/w: General Budget Revenues	66.2	54.7	16.3
Tax Revenues	57.5	47.9	15.3
o/w: Corporation Tax	17.0	14.2	14.8
Tax on Income	6.6	4.6	36.2
Tax on Goods and Services	22.9	19.5	12.7
o/w: VAT	7.3	5.8	21.4
SCT	13.3	11.7	9.6
Tax on Foreign Trade	11.3	8.4	29.9
Non-Tax Revenues	11.3	9.1	18.8
Central Government Expenditures	72.9	68.4	2.5
Non-Interest Expenditures	58.9	53.4	6.1
o/w: Personnel	22.1	19.0	11.9
Gov. Prem. to Social Security Agen.	3.3	2.8	15.5
Good and Services Procurements	4.8	4.2	9.3
Capital Expenditures	1.5	1.0	42.5
Current and Capital Transfers	29.8	28.0	2.4
o/w: Social Security	16.1	15.1	2.4
Transfers to Households	0.5	0.4	23.9
Agricultural Subsidy	2.8	3.2	-14.7
Tre. Aid to Provincial Offices	0.6	0.4	36.7
Interest Expenditures	14.0	15.0	-10.4
Overall Balance	-4.1	-11.3	...
Primary Balance	9.8	3.7	...

Source: Ministry of Finance