TRIGON ASSET MANAGEMENT

Turkey

Turkey has been in the spotlight of financial markets in 2018. Having run twin-deficits for the past decade, and being highly dependent on FX funding needs, the country was caught unprepared for the US rate increase and subsequent dollar strength. Adding to the picture confrontational foreign politics, and highly questionable independence of the central bank, Turkey has lost the trust of the financial markets. In the worst point of the year the lira had lost 42% of its value compared to the euro and the equity markets had given up more than half of its market capitalization in euro terms (53%). 10-year local currency bond yields jumped from 11.3% in the beginning of the year to 21.5% in the middle of the August. Since the total capitulation of the currency and equity prices in late August, the financial markets have recovered, backed by more pragmatic politics and strong statement by central bank in the middle of September, hiking the base rate by 625 bps and taking it to 24%. Since then lira has gained 26% against the euro and 10-year bond yield has come down to 16.5% level.

Despite the normalization of financial stress in the system, Turkey is still a long way out of the woods. Due to the sharp depreciation of the currency, inflation has hit 25.2% in October and is expected to rise further in coming months. State's initiatives of substantially cutting the VAT from the sales of residential property, cars, white goods and furniture in order to lower the CPI at the expense of worsening budget deficit, seems misplaced, as the essence of the crises lies in the over-consumption in past years, over-heated real estate sector and rapid growth of leverage. The latest move is a continuation of the policies that the state has been conducting over the past years in order to keep the "party" going, and imbalances growing, while offering price guarantees to energy sector and interest payment guarantees on SME loans, to name some. Continuation of similar policies would probably help to avoid the sudden slump of GDP in coming quarters but would also substantially prolong the recovery phase. Despite the efforts, the GDP is expected to turn to negative in Q3 and Q4 of 2018.

How much of this is priced in by the market? Turkey is trading at 6.7x trailing 12M P/E ratio which is 33% discount to its own 10-year average. That looks cheap in historical standards but once you

consider that 10- year lira bonds offer 16.5% yield, then the 14.9% earnings yield of equities does not look that straight-forward buying opportunity any more. Additionally, one has to consider the low 3.6x P/E ratio of financials which have a large share in the index, and which ratios can be highly misleading due to their creative provisioning practices.

EV/EBITDA wise Turkey trades at 6.1x which is only a 14% discount to 10-year average, partially also reflecting the high leverage and FX share of Turkish companies.

That said, in the mid-term perspective though, if one expects further normalization of inflation and interest rates, then current levels can start to offer some selective value. We have been, and remain, positive on companies which are exports oriented, or which products/services have less elastic demand, and are therefore able to pass the inflation more easily. Balance sheet quality is also of utmost importance as a company with FX debt but little FX revenue can be a dangerous mix.

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