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UPDATE

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Turkey Economics, Macro, Equity and Sovereign Credit Strategy | Europe

President Erdogan Re-elected

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According to preliminary results announced by the Supreme Election Council (YSK), President Erdogan was re-elected with 52% of votes versus opposition candidate Kilicdaroglu at 48%. Election uncertainty is over but policy uncertainty remains amid rising macro stability risks. Market focus will shift to the assignment of key roles and guidance on policy direction post-elections.

Economics | President Erdogan won the run-off as expected: According to preliminary results announced by the Supreme Election Council (YSK), President Recep Tayyip Erdogan has polled at 52%, exceeding the vote share of Kemal Kilicdaroglu, joint candidate of the Nation Alliance, which stood at 48%. The result was widely expected given President Erdogan's lead of 4.6pp in the first round, and his alliance's win of a comfortable majority in the parliament two weeks ago (Exhibit 2). Latest opinion polls were also pointing to an Erdogan win (Exhibit 1).

What's next: According to the election agenda published by the YSK, there will be a three-day period between May 29-31 for potential objections to be submitted. The YSK will officially announce the final results of the election by June 1, after which a new government will be formed. The next thing to watch will be the assignment of the key roles in the new government, in particular ministers that will be in charge of economic policies.

Given President Erdogan's long-held view that higher interest rates cause higher inflation, we do not expect a reversal in interest rate policy post-elections. However, the recent stress on official reserves amid large external finance needs and high inflation seemingly would require a change in policy direction to contain macro stability risks (Exhibit 3 and Exhibit 4). Whether this is implemented by adjusting the existing policy set, or by a partial return to conventional policies at some point during the president's next five-year term, remains to be seen. We think the former approach is more likely in the short term. The appointment to the MinFin post and potential changes in central bank management would be important signposts as we expect to get more guidance on economic policies to be implemented post-elections.

Policy implications: In the absence of conventional monetary tightening, **post-election macro adjustment,** i.e., external rebalancing, would have to rely more on exchange rate depreciation and a tightening in financial conditions through other instruments and regulations. We think that the policy authorities will adjust alternative instruments, including the CBT's liraisation and reserve-management strategies, to: 1) Let the currency depreciate at a faster pace; 2) Let deposit and loan rates go higher; 3) Restrict loan supply; and 4) Tighten regulatory controls over locals' FX transactions.

The CBT's new liraisation targets for banks, which aim to encourage a 10% monthly conversion from retail FX deposits to FX-protected deposits (KKM), are a step in this direction. In response, banks are offering higher deposit rates on conversions to KKM, which in turn are purchased by the CBT (Exhibit 5 and Exhibit 6). To the extent that the CBT reduces its indirect FX sales, i.e., allows a faster depreciation in the currency, it could see a partial recovery in its reserves in the short term, but this would be a temporary fix as conversions to KKM imply latent FX demand down the road.

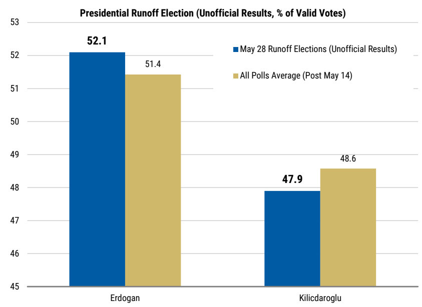
The implied slowdown in domestic demand from 3Q23, along with a smaller energy import bill and a strong tourism season, are factors which would reduce the current account deficit from 2H23 (Morgan Stanley's forecast for 2023 is US$40 billion, with around a US$10 billion cumulative deficit between June-December). A weaker currency and tighter financial conditions could reduce short-term risks associated with reserves loss, but imply high and persistent inflation and a sub-par growth performance in 2H23 and beyond. Without a change in the macro policy framework to prioritise disinflation and to adopt market-friendly policies, Turkey's high external finance needs will likely keep macro risks alive, increasing sensitivity to global shocks (commodity prices, Fed) as well as the availability of FX inflows from regional partners.

Macro strategy: The deterioration in the CBT's net FX reserves position in recent weeks suggests that a more front-loaded adjustment in the currency may be necessary versus our previous expectation for the path in the scenario of victory for President Erdogan. The market has reached the same conclusion, with a more front-loaded adjustment priced in already. Our pre-election scenario note stated that USD/TRY could reach 26 by the end of the year and in a back-loaded fashion. But the risk is that this level is reached sooner, with a higher USD/TRY level by the end of the year, closer to 28, absent a change in policy direction, particularly on interest rates.

Equity strategy: MSCI Turkey has been down 22% year to date with a high degree of volatility and down 13% in USD since the first round. Valuations remains at a large discount to historical levels and the implied CoE (24.6%) is also at high levels compared to history and to other EEMEA markets. However, with risks to TRY building, foreign positioning, which has been on a declining trend in the past years, is likely to remain low. A slowdown in domestic demand is likely to be an additional headwind for domestic-oriented stocks. For the banks, additional banking sector regulations could impact lending activity. Meanwhile, with a high inflationary outlook, in local currency the equity market should continue to have its inflation-hedging appeal to local investors, but not similar to 2022 as KKM have become more attractive as well. In this scenario, on a relative basis, we believe that exporters and companies with FX revenues should perform better.

Sovereign credit strategy: Turkey 5Y CDS and the belly (2033) of the cash curve are 171bp and 164bp wider, respectively, since the first round of voting, which suggests that the preliminary second round election result was fully priced in. We resist the urge to put on mean-reversion trades as investor concerns around unconventional policy orientation could mean that spreads trade in this range in the near term. Bonds could break this range if locals ramp up their purchases of domestic debt, but at a 64% holding locals are at near the highs of 66%, suggesting that the local bid may not be as strong going forward (Exhibit 7). This is consistent with our pre-election note scenario, where we envisaged a sideways movement in spreads with a bias for widening. **For now, we think that it is prudent to remain neutral on the credit.**

Exhibit 1: In line with latest polls, President Erdogan won the runoff with 52% of total votes



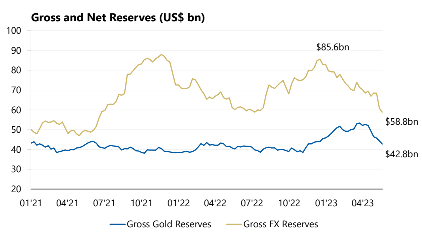
Source: Unofficial results announced by Anadolu Agency (AA), local news, Morgan Stanley Research. (See link for opinion polls)

Exhibit 2: The Erdogan-led People's Alliance has a comfortable majority in a parliament of 600 seats

	Vote Share (%)	Number of Seats
People's Alliance	49.47	323
Nation Alliance	35.02	212
Labour and Freedom Alliance	10.55	65
Ata Alliance	2.43	0

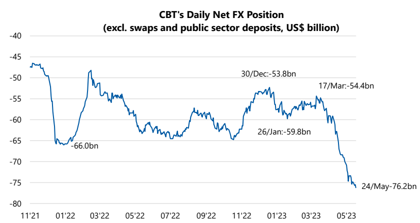
Source: Unofficial results published by Anadolu Agency, local news, Morgan Stanley Research

Exhibit 3: Gross FX and gold reserves have declined by US$27.2 billion year to date as of May 19



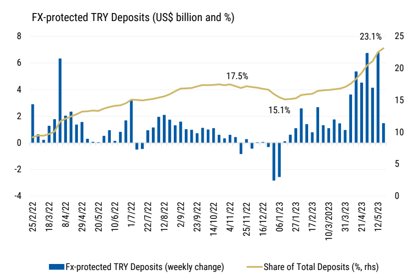
Source: Haver Analytics, Morgan Stanley Research

Exhibit 4: The CBT's net FX position has declined by US$22.4 billion year to date as of May 26



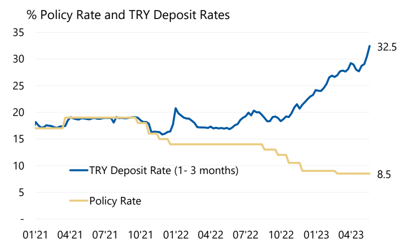
Source: Haver Analytics, Morgan Stanley Research

Exhibit 5: The KKM stock reached US $121.4 billion on the back of tighter liraisation regulations...



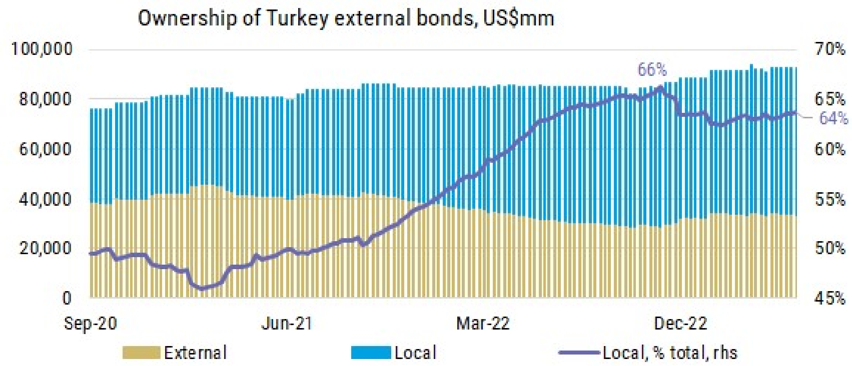
Source: Haver Analytics, Morgan Stanley Research

Exhibit 6: ...which has led to a notable rise in deposit rates



Source: Haver Analytics, Morgan Stanley Research

Exhibit 7: Local holdings of external debt are nearing the recent highs



Source: Haver Analytics, Morgan Stanley Research

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Underweight/Sell	639	17%	70	11%	11%	228	15%
Total	3,661		647			1549	

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