Emerging Insight

Türkiye – Q1 2024 might be the time to receive rates

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GEM Fixed Income Strategy & Economics
Global

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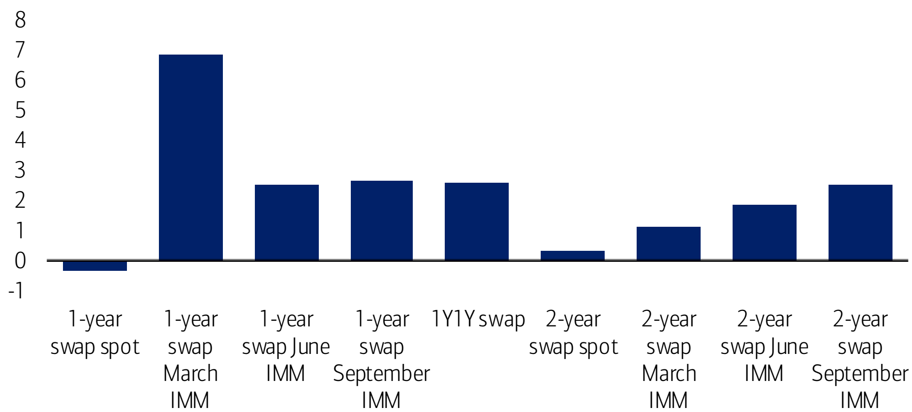
Key takeaways

- Receive around the last hike - a universal rule that might also work in Türkiye. We see last hike in December (250bp).
- However, a receiver trade is more likely to start in Q1 if cuts in 2024 are priced out after TRY depreciation and Q1 data.
- Better to receive in OIS (if liquidity improves) as bond positions will suffer from FX depreciation (FX hedge is expensive).

By Zumrut Imamoglu and Mikhail Liluashvili

Chart of the day: The market is dovish relative to our baseline forecast
The chart shows market pricing of OIS swaps minus BofA expectations



Source: Bloomberg, BofA Global Research

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Türkiye: Q1 might be the time to receive

We believe the best time to receive rates will be in Q1, after the last hike by the CBT. More data is needed to see how fast the adjustment in macroeconomic imbalances will be. The market should also price out cuts in 2024 before receivers start to work, in our view. We expect no cuts next year as we see inflation at 40% at year-end 2024. We don't think the CBT would make a premature cut only due to improvement in year-over-year inflation which is driven by base effects. We believe the bank will wait until all data point to a strong disinflationary trend which we think will start in 1Q25.

For a list of open trade recommendations and trade recommendations closed in the last 12 months, see Global Emerging Markets Weekly: End-year rally – or end-year run? 10 November 2023

Abbreviations

EEMEA is Emerging Europe, Middle East and Africa

FX is foreign exchange

CBT is central bank of Türkiye

IMM is International Monetary Market

OIS is overnight interest rate swap

CDS is credit default swap

Receive OIS swaps in Q1 next year if 2024 cuts are priced out

Rates usually peak around the last hike by the central bank. This rule holds in all EEMEA countries with liquid IRS curves. This rule of thumb is more applicable to the front end, but the long end is highly correlated with the front end in many countries (including Türkiye).

BofA Global Research Reports

Title: Subtitle	Primary Author	Date Published
Emerging Insight: Front-end rates: the most inefficient market in EEMEA	GEMs FI Strategy & Economics	16 August 2022
Emerging Insight: No structural receiver in Czech swaps until inflation falls more decisively	GEMs FI Strategy & Economics	14 September 2022

However, the market is likely to be more cautious with Türkiye receivers than in other countries because: 1) investors need to be sure the CBT has delivered enough tightening through interest and quantitative channels to rebalance the economy; 2) too many cuts are already priced in for next year, since we expect none; 3) the market started to receive too early in some countries this year (for example, in Czechia and Poland). For more details, please see the following reports listed below.

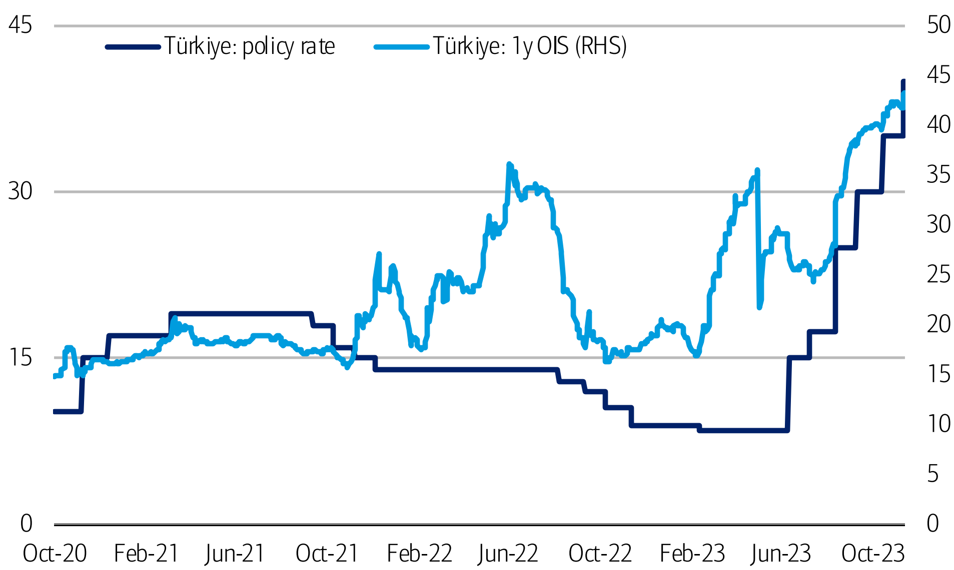
Moreover, in the short-term EM assets look overbought and TRY volatility is at the rock-bottom lows. It seems that the market is pricing in a perfect scenario for Türkiye which makes us skeptical about receiving now.

Front end should be more correlated with the policy rate in Türkiye from now on

In Türkiye, the correlation between the policy rate and the front end of the OIS curve has been weak historically. We attribute this to the CBT's unorthodox polices. With inflation targeting becoming the main goal, the correlation between the front end and the policy rate should become high again – like other EEMEA countries. We are already seeing an increased correlation between the 1y swap and the policy rate during the current hiking cycle (see Exhibit 1).

Exhibit 1: 1y and 2y OIS should become more correlated with the policy rate

Inflation targeting by the central bank should help



Source: Bloomberg, BofA Global Research

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5y and 10y is a function of 2y and a credit component (CDS)

The 5y and 10y OIS in Türkiye is a function of 2y swaps as well as a credit component that can usually be proxied by the CDS. Our Dynamic Ordinary Least Squares regression suggests the 2y swap is the most important driver of both the 5y and 10y (on monthly average frequency), followed by the CDS, as the t-statistic is much higher for the 2y OIS compared to CDS (Exhibit 2). Unlike other EEMEA countries, US rates are not significant in our regression, most likely due to high inflation and unorthodox monetary policy. With policy normalising and inflation falling, we would expect core rates to become the third most important driver after 2y swap and CDS.

Exhibit 2: Regression coefficients of 5y/10y OIS on 2y OIS and CDS (t-statistics in brackets)
CDS also matters, but much less so, core rates are insignificant (estimated using DOLS approach)

	2y OIS	CDS	Constant
5y OIS	0.804 (26.1)	0.007 (3.60)	-0.182 (-0.22)
10y OIS	0.680 (18.81)	0.006 (0.008)	1.40 (1.47)

Source: Bloomberg, BofA Global Research

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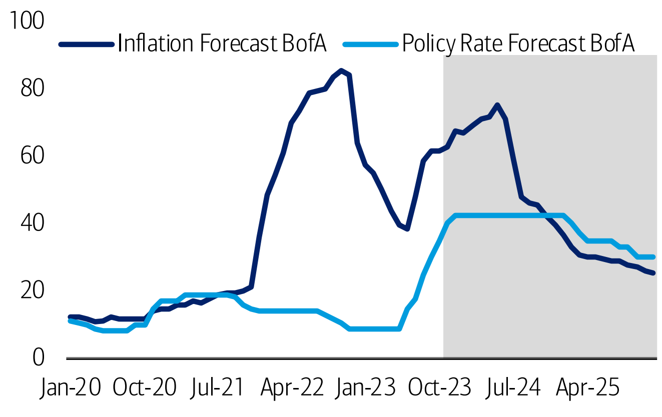
When the central bank is on hold for a long time, receivers might not work

The above suggest that monetary policy is the key driver for the whole OIS curve and getting the last hike right is extremely important even for 10y receivers. Moreover, the experience of Czechia shows that it's important to get the first cut right as well. When the central bank is on hold for a prolonged period, it is difficult for the market to price in a lot of cuts into the curve because of the negative carry.

There are other reasons that the market does not fully price in upcoming cutting/tightening cycles. First, monetary policy cycles are usually long, and the forecasting ability declines as horizons get longer. This suggests the market prices in monetary policy more effectively closer to the actual decisions. The second is that the market requires a risk premium that rises over time, in case the market forecasts are wrong. And, in the case of Türkiye's cutting cycle, the risk premium is likely to be large given the history of high inflation and unorthodox monetary policy.

Exhibit 3: Inflation forecast path
We see inflation peaking by May at 75% and 2024 year-end at 40%.



Source: TurkStat, BofA Global Research *Shaded area indicate forecasts, data otherwise

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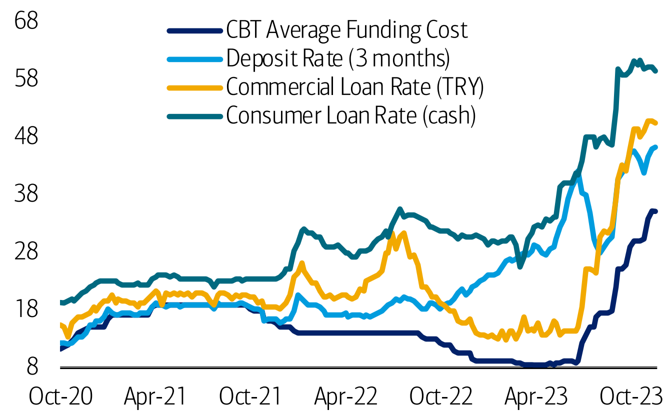
Exhibit 4: Deposit and Loan rates, %
TRY deposit rates and commercial loan rates edged lower



Source: Haver, CBT

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The market seems too hawkish in the short term and too dovish for next year

The market expects the peak of the policy rate at 45% in December/January, while we see it at 42.5%. At the same time, we do not expect any cuts next year, while the market prices the end-2024 policy rate at c.38% (BofA forecast is 42.5%). Overall, the OIS curve looks to be pricing in too many cuts too early (except the 1y swap). This should make it difficult to receive unless the market might price out cuts for 2024 (see Chart of the Day).

Moreover, bid/ask spreads for OIS are quite wide, making it even more difficult to receive.

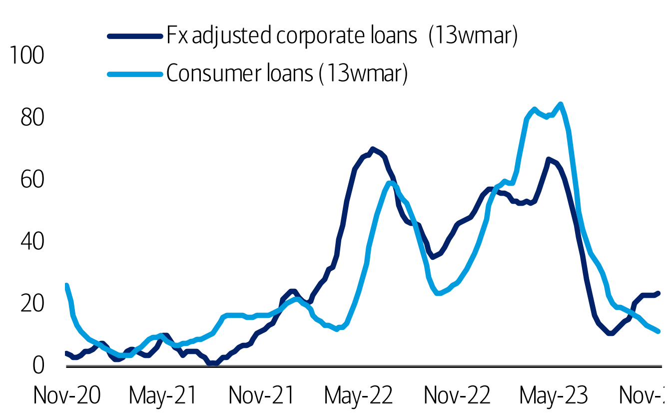
CBT believes lending rates now in-line with targeted level of financial tightness
After delivering a surprise 500bp hike, the CBT stated that it will decrease the pace of hikes and end its hiking cycle "in a short period of time". The guidance points to usage of quantitative tools and regulations to continue. The CBT seems to have reached its "targeted level of financial tightness" in terms of "lending rates". It has kept the credit card interest rate stable despite hiking 500bp. We believe the CBT hike is more for the sake of normalisation than further credit tightening. Indeed, consumer loan rates have reached levels where the monthly cap of 3% growth is no longer binding, due to a lack of demand. Therefore, we believe it will deliver hike of 250bp in December and end its hiking cycle at 42.5%.

An additional hike in January could be on the table if the minimum wage increase is significantly higher than the CBT's inflation forecast. However, even if the terminal rate reaches 45%, we do not see a rate cut until 1Q25. Although inflation will fall very fast in 2H24 due to large base effects, we don't think the CBT will make a premature cut as this has proven too costly in the past. We believe the market is pricing cuts too early in the curve.

FX is the biggest headwind for bond positions for international investors
The biggest headwind for long bond positions in Türkiye is further FX weakness. In our baseline forecast, we expect the TRY to depreciate in line with forwards. Recently, TRY depreciation has been quite even over time and slightly below monthly inflation levels. However, the election calendar and timing of the minimum wage increase makes it harder to envisage the same monthly pace early next year.

Even depreciation in line with the forwards would be a drag on the long bond positions, we think, which is why the initial leg of the receiver trade should focus on OIS receivers. Forwards imply about 2.5% depreciation of the lira per month. Bond prices are unlikely to increase significantly to justify the risk of holding bonds as we expect cuts to start in 2025.

Exhibit 5: FX-adjusted loan growth, 13-week ma, annualized %
Consumer loan growth continues to slowdown



Source: Haver, CBT

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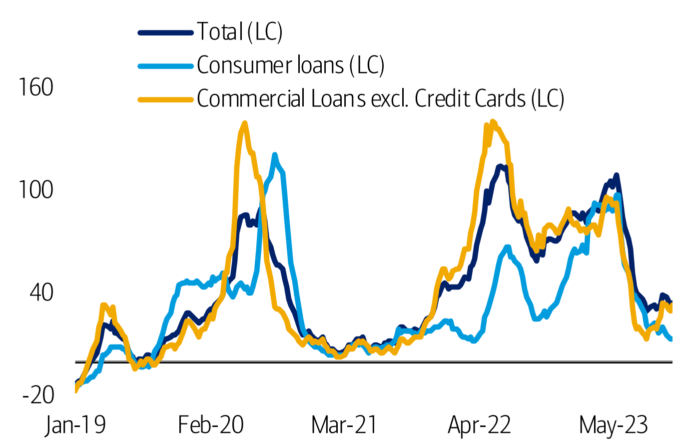
Exhibit 6: Local currency loan growth, 13-week ma, annualized %
Local currency loan growth slightly eased



Source: Haver, CBT

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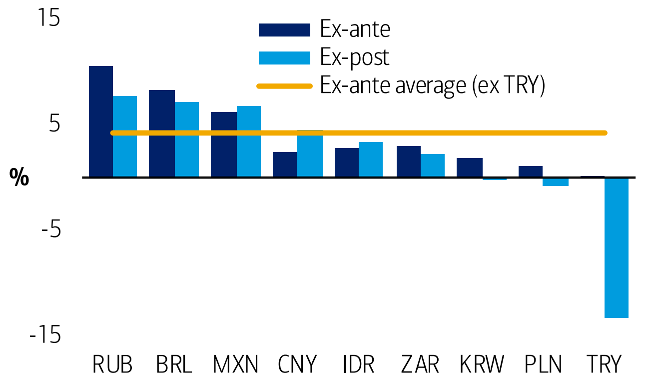
Exhibit 7: Ex-post and ex-ante real rates in EM, %
Türkiye ex-ante real rates small positive now



Source: BofA Global Research, Bloomberg

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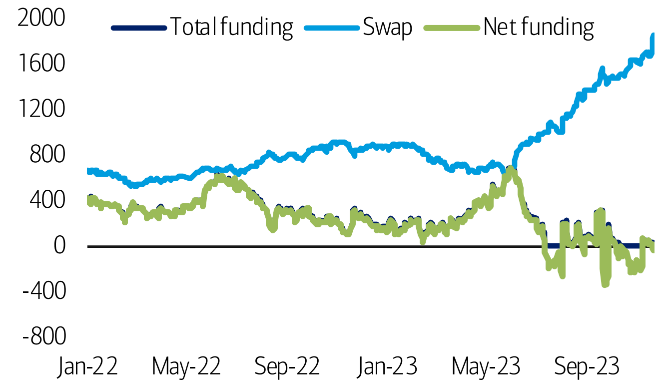
Exhibit 8: CBT funding and swaps with banks, TRY bn
Bank swap increase drives net funding to negative



Source: CBT, Haver

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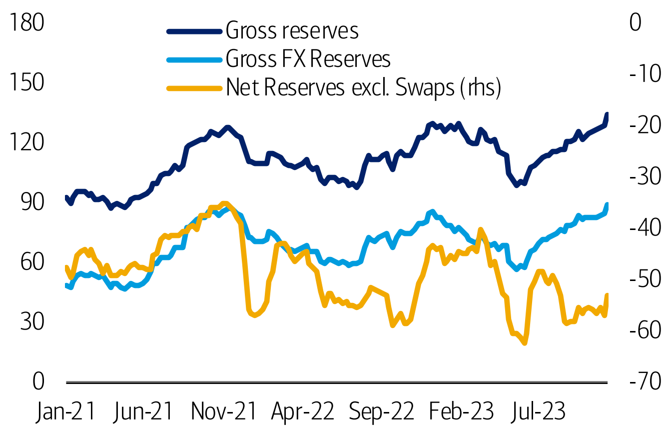
Exhibit 9: Gross and net reserves(rhs), USD bn
Net reserves excluding swaps are still deeply negative at -$53bn



Source: Haver, CBT

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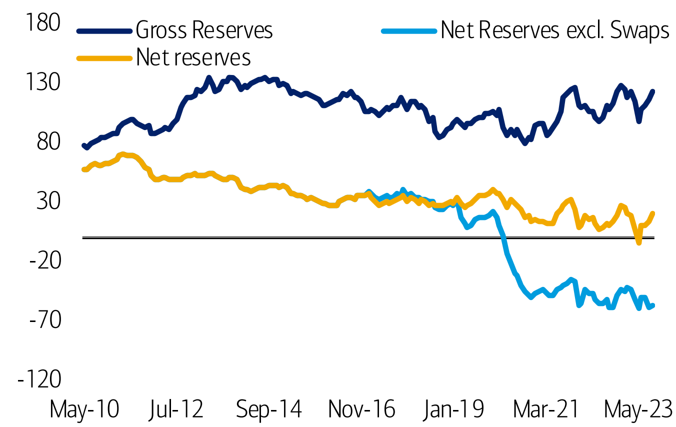
Exhibit 10: Long-term view of reserves, USD bn
Reserve accumulation remains limited.



Source: Haver, CBT

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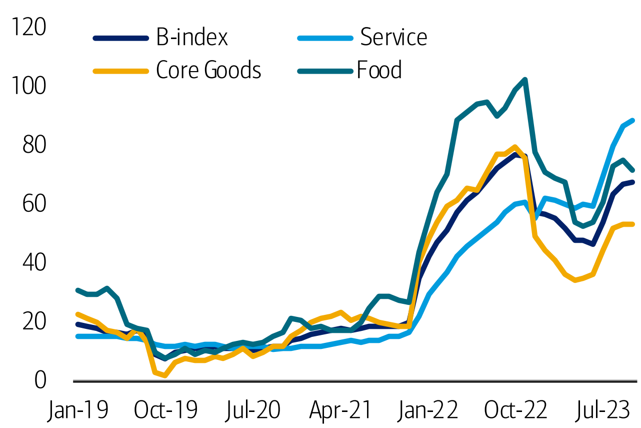
Exhibit 11: Inflation components, % yoy change
Services inflation hit 88.7% while core goods were 53%



Source: Haver, TurkStat

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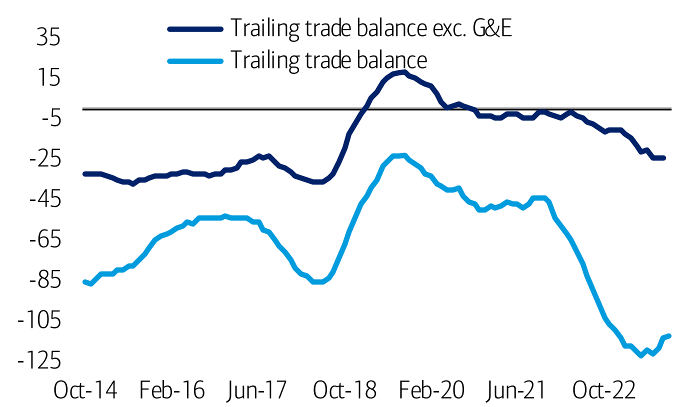
Exhibit 12: 12-month trailing trade deficit, USD bn
Excluding gold and energy (G&E) trade balance correction yet to start



Source: Haver, TurkStat

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News and Views

Mexico: Retail sales decreased 0.2% mom sa in September

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Retail sales in September surprised to the downside at -0.2% mom sa (E. 0.4%, BofA -0.1%), up from -0.5% mom sa in August (revised down from -0.4%). Employment in retail decreased 0.4% mom sa (vs 0.0% in August) while wages increased 0.4% mom sa (vs 1.6% in August). However, wholesale sales increased 3.9% mom sa (vs 3.6% in August). In annual terms, retail sales increased 2.3% yoy nsa (E. 3.7%, BofA 3.1%) while wholesale sales rose 7.1% yoy nsa.

- **To follow**: The acceleration in wholesale sales anticipates future strengthening in retail sales. We recently reviewed consumption's determinants and most are still going strong (see consumption report Emerging Insight: Mexico: Consumption is outpacing GDP 19 November 2023)

Mexico: Headline inflation was above expectations in 1H November at 0.63%

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Biweekly headline inflation was above expectations in 1H November at 0.63% (E. 0.60%, BofA 0.61%). However, core inflation was slightly below expectations at 0.20% (E. 0.21%, BofA 0.26%). The main driver to the upside for headline was non-core inflation at 1.96%, which in turn was driven by energy prices at 4.00% (electricity at 22.26%) and livestock inflation at 1.32% (egg at 7.83%). Core inflation was mainly driven by (processed) food inflation at 0.27% (sugar at 2.82%) and services excluding housing and education at 0.42% (airfare at 11.59%), and the main downward driver was non-food merchandise inflation at -0.04% (T.V.s at -2.29%). In annual terms, headline inflation increased to 4.32% yoy from 4.25% yoy, while core inflation kept falling and is now at 5.31% yoy from 5.46% yoy a fortnight ago (services fell to 5.28% yoy from 5.35% yoy).

- **To follow**: There was an impact from the hurricane Otis as inflation fell 2.32% in Acapulco (there could be payback in the following prints). We still see core as too high for Banxico to cut anytime soon, but Banxico may focus more on the downward trend.

Mexico: Banxico Minutes suggest Doves might be outnumbering Hawks

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Minutes of the Banxico meeting on November 9th are out. All board members agree the drop in inflation has been significant, the majority highlighted the downward inflation trend, and most see a favorable core inflation evolution. 3 out of 5 Banxico board members mentioned 1Q in the context of potentially cutting rates, although the three of them said that cuts would be gradual and probably non-sequential. Irene Espinosa had a dissenting opinion on the statement. She did not want to change the forward guidance. She thinks that upward bias in the risks to inflation has increased (due to resilience of the economy, cyclical position, tight labor market, core inflation persistence, non-core trending upwards, inflation expectations above target and procyclical fiscal policy). And she points to the "enormous" challenge to attain fiscal consolidation in 2025.

- **To follow:** Minutes of the central bank read dovish. As anticipated in the statement, most board members are thinking about a gradual “fine tuning” of the policy rate to the downside that could start as soon as 1Q 2024. One of the dovish board members talking about a cut as soon as 1Q is likely to be the governor. There is disagreement building among board members. One very dovish board member already sees convergence to the 3% target. One sees growth as too strong for Banxico to cut soon. The latter is likely to be Espinosa (she is the most hawkish member of the board). We agree with all her points, but we think that the rest of the board will outvote her in 2024. All-in-all, we think Banxico wants to cut in 1H, maybe even 1Q. We think that if it does, it would be at most two 25bp cuts in 1H. We maintain our view that the first cut is likely to happen until after the election (in June 2024) as inflation is already increasing again and we see upside risks in the following months. However, irrespective of the timing of the first cut, we think Banxico has a lot of room to cut in 2H 2024 and in 2025 when we expect the economy to decelerate substantially (we have the policy rate at 8.75% by end 2024 and at 7.5% at end 2025).

Mexico: GDP growth surprises to the upside at 4.35% qoq saar in 3Q

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GDP growth in 3Q above expectations at 4.35% qoq saar (E. 3.24%, BofA 3.65%), up from 3.79% qoq saar in 2Q. By components, services increased 3.76% qoq saar (vs. 2.55% in 2Q), industry increased 5.36% qoq saar (vs. 6.13% in 2Q) while agriculture increased 11.01% qoq saar (vs. 9.30% in 2Q). In annual terms, GDP increased 3.31% yoy nsa (E. 3.20%, BofA 3.30%). Year to date, GDP increased 3.41% sa (vs. 3.75% last year).

- **To follow**: Growth continues to surprise to the upside in Mexico, helped by construction. This will continue to put pressure on domestic inflation.

Mexico: Monthly GDP (IGAE) surprised to the upside in September at 0.60% mom sa

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Monthly GDP (IGAE) surprised to the upside in September at 0.60% mom sa (E. 0.20%, BofA 0.20%), from 0.45% mom sa in August (revised from 0.39%). By components, the main driver to the upside was services at 0.90% mom sa (vs 0.37% in August), where transportation, mailing and storage increased 2.38% mom sa; industry increased 0.15% mom sa (vs 0.32% in August), in which case manufacturing drove the increase at 1.66% mom sa; on the other hand, agriculture decreased -2.99% mom sa (vs +2.29% in August). In annual terms, IGAE increased 3.34% yoy nsa (E. 3.00%, BofA 2.95%). Year-to-date, IGAE has increased 3.40%.

- **To follow**: Economic activity continues to surprise to the upside. At the margin, services were strong in September, which means services inflation will remain under pressure.

Mexico: Current account balance with a surplus in 3Q-2023

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The current account balance in 3Q-2023 showed a smaller-than-expected surplus at US$2.6bn (E. surplus US$2.8bn), in contrast to a -US$6.4bn deficit a year ago. The surplus in 3Q-2023 is 0.6% of GDP (vs. -1.7% of GDP a year ago). The surplus was mostly due to a large secondary income surplus (remittances) at US$16.7bn (vs. US$15.5bn last year). Meanwhile, the financial account showed outflows for +US$4.3bn (vs. inflows of -US$7.0bn last year). This accounts for 0.9% of GDP (vs. -1.9% of GDP last year). Net foreign direct investment (FDI) came in with an outflow of +US$1.8bn (vs. an inflow of -US$2.1bn last year) as FDI into Mexico decelerated substantially to US$1.8bn from US$3.5bn a year ago (and US$7.7bn in 2Q). Net portfolio investment came in with an outflow of +US$7.5bn.

- **To follow**: So far this year, the CA shows a deficit of 1.1% of GDP, smaller than a year ago at 1.9% of GDP, and it continues to support MXN. Nearshoring is not showing in FDI and foreigners continue to sell Mexican securities

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