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MARKET INSIGHTS

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Turkey: The winding path to growth

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Introduction

We expect the next few years to be characterised by sub-par economic growth at a global level. In this environment investment strategies focused on discovering the highest growth areas of the world are gaining in popularity. We think that the best approach could be to find countries that are not only seeing strong economic growth, but where the economic outlook is boosted by structural reform backed up by strong government. In this paper we look at the reasons why, based on these criteria, Turkey merits a closer look from investors.

Summary

Turkey is one of the fastest growing emerging market economies, having recovered strongly from the global downturn thanks to a rebound in consumer demand and investment. The Turkish stock market is also attractively valued and is benefiting from strong earnings momentum, while a backdrop of political and economic reform is leading to secular long-term investment opportunities.

However, Turkey's prospects must be considered in relation to its slow progress towards entry into the European Union (EU). The recent approval of the constitutional referendum is a step in the right direction and could herald the start of a period of political stability, which would be favourable for markets and would also help boost social and economic reforms.

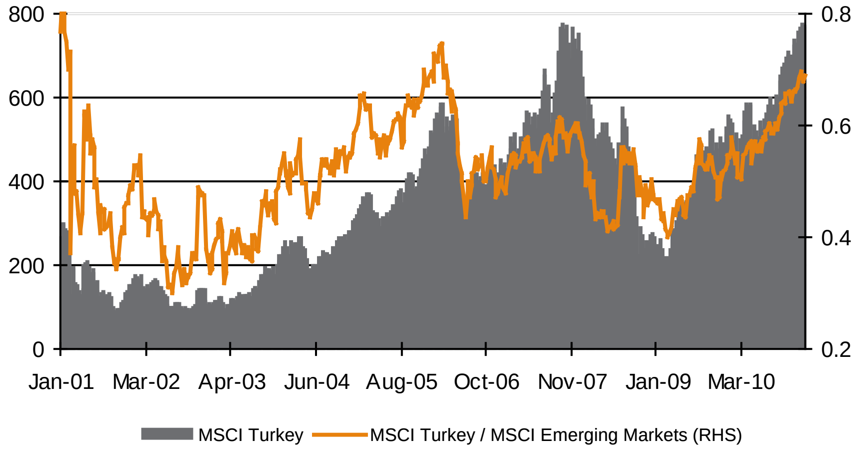
Turkish growth is among the strongest in emerging markets

GDP growth in the first two quarters of 2010 put Turkey in the top rung of fast growing emerging nations. Domestic private consumption and investment are driving the recovery, but the economy is also benefiting from structural trends related to the country's demographic profile and the modernisation of its industrial production systems.

In the last few months the three major credit rating agencies (Moody's, Standard & Poor's and Fitch) have raised their outlook for Turkey, highlighting the Turkish government's well-timed reaction to the financial crisis together with its strong financial system. Furthermore, a referendum in September strongly approved a set of constitutional reforms mainly related to the judicial system. These reforms remove a significant obstacle from Turkey's EU entry and could create a long period of political stability.

The Turkish equity market has rebounded strongly since the beginning of 2010, accelerating in the last few months along with other emerging economies. Turkey's financial market is improving in terms of efficiency, liquidity and the range of financial instruments available. Earnings momentum is positive and valuations are appealing.

Exhibit 1 – **MSCI Turkey Index vs MSCI Emerging Markets (USD based)**



Source: Bloomberg. J.P. Morgan Asset Management data as at 15 October 2010.

Private consumption is rising and the demographic profile is favourable

The investment case for Turkey is mainly based on growth. In the first and second quarters of 2010, GDP improved by 11.7% and 10.3% respectively, in line with other top performing emerging markets and especially with China. Growth is expected to slow in the second half of the year. Nevertheless, the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) estimate Turkey's GDP will grow by more than 6% for 2010 as a whole, which is still at the high end of the range for emerging economies.

Private consumption and investment are the main drivers of the strong recovery, together with exports. The fiscal stimulus introduced by the Turkish government to sustain the recovery after the recent recession has been successful. The unemployment rate has declined rapidly from a peak of 16% in February 2009 to 10.5% in July 2010. Consumer confidence is improving due to subdued inflation expectations and positive sentiment in terms of current and future economic conditions.

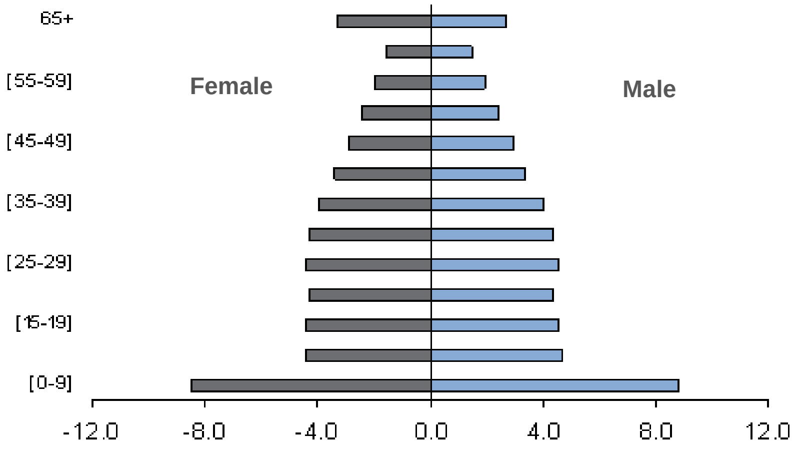
"A high proportion of young people supports a strong recovery in consumption…"

Turkey also benefits from structural demographic changes that will support consumption growth. A high proportion of young people supports a strong recovery in consumption with the substantial presence of 0-30 year-olds reinforcing expectations of persistently high consumption levels in the next few years.

Turkey can be considered at an intermediate stage in terms of development. However, there is still a lot of room for growth in many areas. Turkey's GDP per capita (around USD 11,500 in 2009*) puts the country in the middle of emerging market nations. Mobile phone penetration has reached 83% of the population, while internet access is still limited to 33%. Urbanisation has reached almost 70%, but in many areas social and educational levels are very low. In terms of financial evolution, credit card diffusion is more advanced than in many other emerging countries, but on the other hand mortgages represent only a very small share of Turkish GDP, due to previous hyperinflation problems.

*Note: according to CIA World Factbook, September 2010.

Exhibit 2 – **Turkish demographic profile in 2010**



Source: United Nations, J.P. Morgan Asset Management. Data as at August 2010.

"… EU entry process has provided a catalyst to… hasten its economic reforms."

Investment is supported by a more stable environment

The EU entry process has provided a catalyst to the government to hasten its economic reforms. As a result, several key reforms have taken place in the last decade – in particular, the liberalisation of foreign investments and a wide privatisation programme, mainly in the utility sector. The disinflation process since the beginning of 2000 has been notable and reflects a strong commitment in terms of focused monetary policies and productivity improvements.

The government of prime minister Erdogan has been strongly proactive in introducing stimuli to limit the impact of the 2008-09 financial crisis. VAT reductions for some specific goods were introduced, as well as tax cuts for small and medium-sized companies. A drop in interest rates and a huge liquidity injection from the central bank have helped stimulate the recovery despite the economic weakness in western Europe, which is Turkey's main trading partner. Helped by these incentives, the Turkish economy has recovered strongly and quickly from the depths of recession in the fourth quarter of 2009.

An drop in interest rates and a more stable rate of inflation has created a suitable environment for private investment. Public investment is also expected to increase with elections looming next year. The country has no major constraints in terms of public debt, which currently stands at less than 50% of GDP and has consistently improved over the last few years.

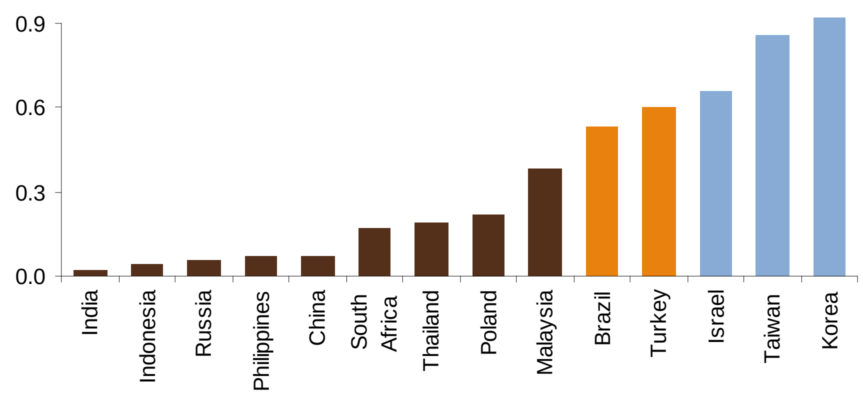
Turkey's structural trade deficit

"40% of Turkey's exports are to its European partners…"

The Turkish economy is open to international trade. An increase in industrial production (IP) is being driven by exports, which had rebounded by roughly 15% year on year at the end of August 2010. IP is also being boosted by a very rapid modernisation process that is pushing up imports of intermediate goods required for the engineering and automotive sectors in particular. This demand for intermediate goods is why Turkey is running a structural trade deficit.

In terms of international trade 40% of Turkey's exports are to its European partners (led by Germany, France and the United Kingdom), followed by a smaller proportion to the Middle East. The main suppliers of goods imported by Turkey are Russia, Germany and China.

Exhibit 3 – **Credit cards per capita**



Sources: UBS as at fourth quarter 2008

Despite the country's trade deficit the Turkish lira has rebounded significantly, supported by positive investment flows and aided mainly by a weaker US dollar. The exchange rate versus the euro appears less volatile due to more stable commercial and financial flows. Turkey's trade deficit does put a limit on the lira's strength, but investment flows are currently prevailing and helping to produce a favourable currency stance.

Expansionary monetary policy

Turkey's strong consumer rebound led to a pick up in inflation, which surpassed 10% at the beginning of the year. However, inflation moderated in the following months. In September, the Turkish central bank left interest rates unchanged at 7%. From the minutes of its interest rate setting meeting, it emerged that the bank intends to maintain its expansionary monetary stance despite economic growth exceeding its estimates.

The central bank is more focused on supporting growth than it is worried by inflation risks, so has started to withdraw liquidity from the system rather than raise interest rates. The central bank expects inflation to be close to 6.5% at the end of the year, compared to more than 9% in September 2010, as production growth and consumption growth slow.

Strong financial sector

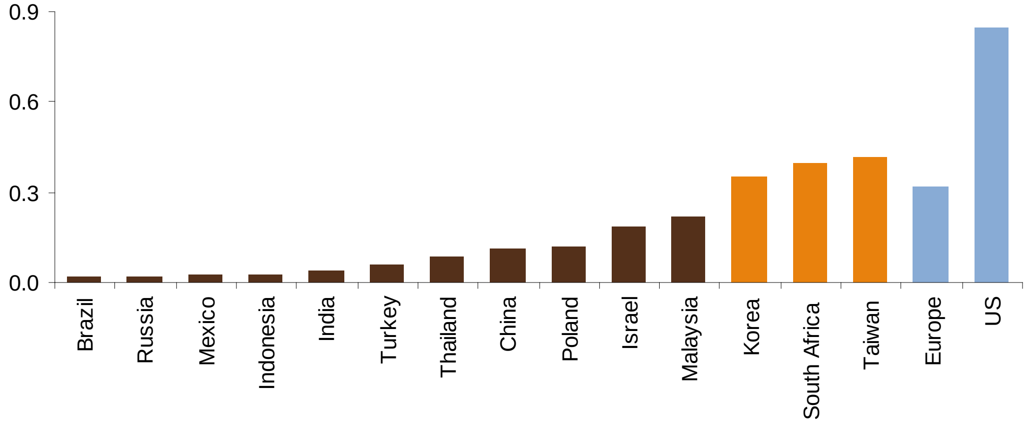
Turkey's resilience to the international financial turmoil highlighted its strong banking system, which came out of the global financial crisis better than most other emerging and developed countries without the need for any international financial aid.

Turkey's banks benefited from high liquidity levels, a low degree of dependence on foreign investors and relatively low loan/deposit ratios. The resilience of the banks was also helped by the better public management and inflation control policies that Turkey had put in place following a previous financial crisis in 2001.

Ratings upwards revision trend

In previous months, the three main credit rating agencies improved their ratings for Turkey, highlighting the proactive reaction by the government to the 2008-09 financial crisis, the reduction in public debt levels compared to GDP, and the financial stability of the Turkish economy. The country is still rated below investment grade level due to its high trade deficit, but its credit rating is rapidly improving. The level of public debt as a proportion of GDP has fallen from 90% in 2002 to roughly 50% today, which compares favourably with an 80% average for eurozone countries.

Exhibit 4 – **Mortgages / GDP (%)**



Source: UBS as at fourth quarter 2008, US & Europe mortgage data includes securitisations

Some risks

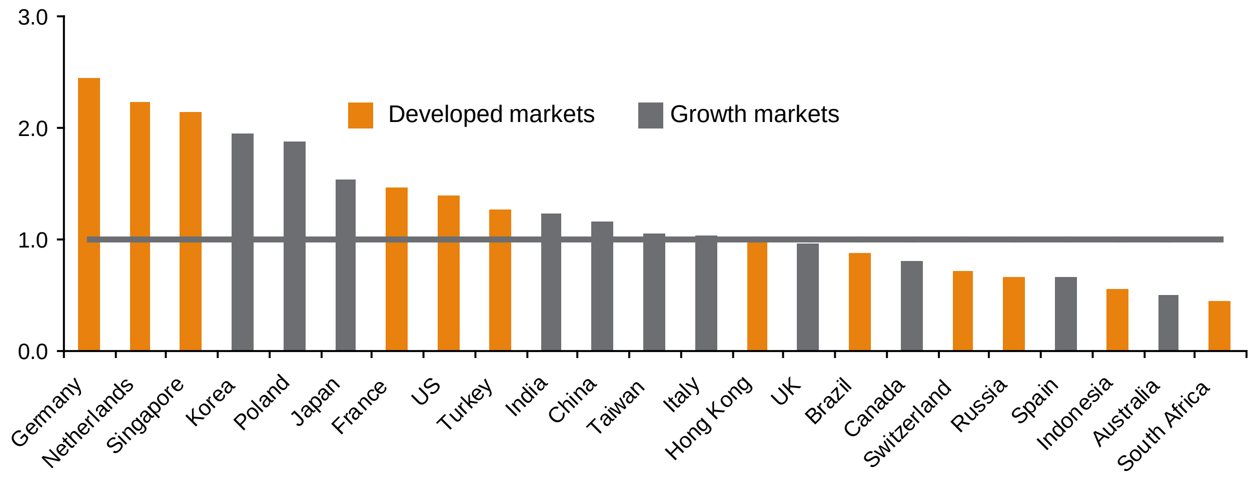
Turkey's development model still reflects some structural weaknesses.

- First, Turkey has a high dependence on Europe for trade, which is a concern given the weakness of the European economy.
- Second, Turkey's exports are concentrated in a few sectors like auto components and mechanical equipment, which are very cyclical and could suffer if the global economy turns down.
- Third, Turkey remains susceptible to political volatility.

The country still finds it difficult to promote real secular political management. The current mildly Islamist government is viewed with suspicion by other parties and the international community, which in turn is slowing Turkey's move towards EU entry.

A recent referendum by Mr Erdogan's government approved a set of constitutional proposals mainly focused on justicial, social and political reforms that represent a significant step in terms of Turkey's modernisation. These reforms, if successful, could help clear the way for Turkey's entry into the EU. In addition, support for Mr Erdogan's proposals reinforce his majority and have helped increase the popularity of his government – a factor that could create a more stable political environment and help produce the conditions for further reforms.

Exhibit 5 – **Earnings upgrades / downgrades ratio**



Source: Thomson Datastream, J.P. Morgan Asset Management Global Multi-Asset Group. Data at September 2010

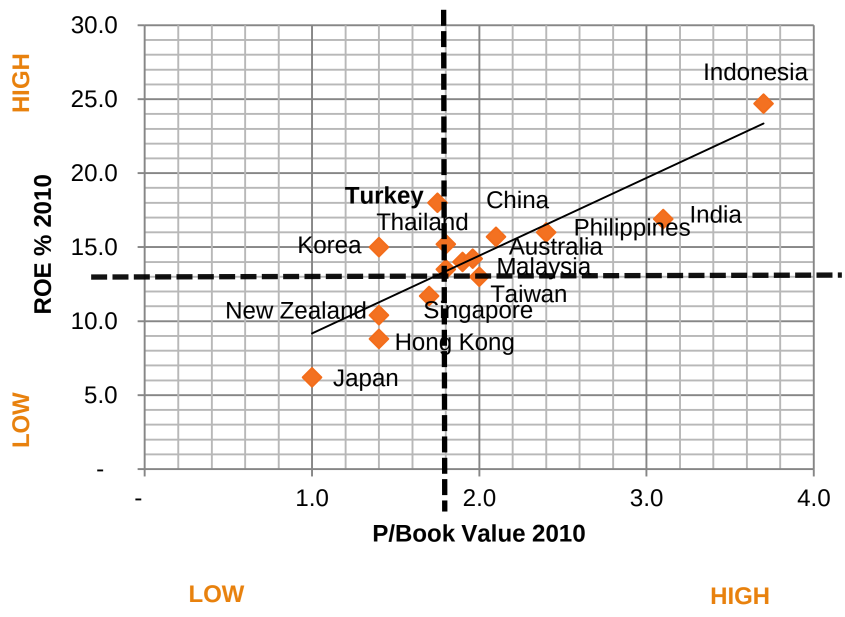
Improving market fundamentals

The MSCI Turkey Index has rebounded since the beginning of the year by roughly 40% (USD terms), with performance accelerating in the last few months compared to the emerging market average. The market is improving in terms of liquidity, consistency and the availability of financial instruments.

Some constraints remain, like the strong sector concentration in financials. Roughly 60% of the index is represented by the financial sector, followed by discretionary goods and telecoms, which each have a 10% weighting. The top three listed banks, Turkie Garanty, Isbank and Akbank, have a total index weight of more than 30%. Meanwhile, the industrial weighting is limited to 5% and the utility sector makes up a negligible 1%. We expect the privatisation process now underway to increase investment opportunities and help widen the sector offering.

Turkish earnings momentum is positive, with the market currently at attractive valuation levels. Considering the value map (**Exhibit 6**), which is built on the correlation between return on equity (ROE) and price-to-book estimates for 2010, we see that Turkey is positioned in the more suitable area of the map, with high profitability and low valuations.

Exhibit 6 – **Earnings upgrades / downgrades ratio**



Source: IBES, MSCI, Factset, J.P. Morgan Asset Management estimates. Data at September 2010.

Conclusion – Turkey is one of the most attractive emerging markets

The investment case for Turkey offers a lot of opportunities for the following reasons:

- Growth is supported by cyclical factors, such as a rebound in consumer confidence, as well as structural dynamics, such as a youthful demographics and the modernisation of industrial production systems.
- Rating agencies have highlighted the Turkish government's proactive support for the economy. The support of Mr Erdogan's government could create a more stable political environment suitable for social and economic reforms.
- Stock market fundamentals are improving. Earnings momentum is favourable and valuation levels are appealing. However, the equity market is still under-represented in terms of sectors.

Positives	Risks
▪ High growth dynamics supported by domestic private consumption and investment. ▪ Expansionary monetary policy expected to remain unchanged for some time. ▪ Stronger political stability after referendum approval. ▪ Strong earnings momentum and attractive valuations.	▪ Religious issues could be an obstacle to EU entry, which is taking longer and is more difficult than had been expected. ▪ A high dependence on Europe for trade could limit the expansion of Turkey's export sector given Europe's economic weakness. ▪ Despite recent reforms, political risks remain high. ▪ The equity market index is still under-represented in terms of sectors.

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