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Turkey Market Outlook
June 4, 2024

Turkey on cusp of a powerful cyclical (not structural) dis-inflation trade.

After many years in the macro wilderness, markets are embracing Turkey's return to monetary credibility. Since the local elections, Turkey has seen sizeable inflows into Turkish Lira fixed income assets and a rising bias to hold Turkish Lira deposits among domestic investors. Although YOY inflation has risen persistently hitting 75.5% in May, the normalisation of monetary policy (driven by a refreshingly independent and clear-eyed Turkish Central Bank Governor), has given the markets confidence (so too have opposition wins in the local elections which have given historic secular pools of capital enough hope to delay "diversification" driven capital outflows). With added scope for geopolitically driven FDI and with scope for long absent Emerging Market equity investors to add a position or two, Turkey is likely to face a prolonged of period of net inflows that are supportive of further real appreciation of the Turkish Lira (to the further dismay of Turkish exporters). While Turkey looks like one of the clearest macro trades in the world for those that think about USD returns, it is largely conditional on the government's making good on its commitment not to raise the highly stimulative minimum wage further in July.

The bad news is dis-inflation will be consumer led meaning this is not a typical cycle where inflows into Turkish assets correspond with strong demand. Yes, in time we will see rate cutting that should help cyclically, but even if this dis-inflation story fully plays out through 2025 and into 2026, collateral damage is likely to be seen in underwhelming employment growth and rising youth unemployment. That will likely be true test of Turkey's policy commitment to remain an investable market. But that potential political tension with disinflation is unlikely to be a concern for many quarters and possibly not until 2026.

Central Bank is doing its job, now over to Simsek & Erdogan on the minimum wage

While the Central Bank has taken increasingly aggressive action to slow growth driven inflation, it is now over to the government to make the most important economic decision facing the country. Namely to stem the rampant minimum wage hikes that have driven both consumption and macro-wide cost push driven inflation. In the Cribstone view, the single greatest driver of Turkish inflationary pressures has been the extreme growth in minimum wages. The decision (due before the end of June) is not under Economy Minister Simsek's portfolio and instead is a political decision and Erdogan will make the final call. As such, the pending decision on the minimum wage in July, will provide a very clear indication of how serious the government is about forgoing populist growth in favor of sustained dis-inflation.

If there is no hike in the minimum wage as was meekly promised in December and again in April by the Labor Minister, then dis-inflation is likely to prove rapid and Turkey's powerful local currency fixed income trade will likely accelerate in the coming quarters. In this scenario pricing and wage policy will be driven by supply and demand rather than pass through from universal wage cost push. However, if they hike the minimum wage by

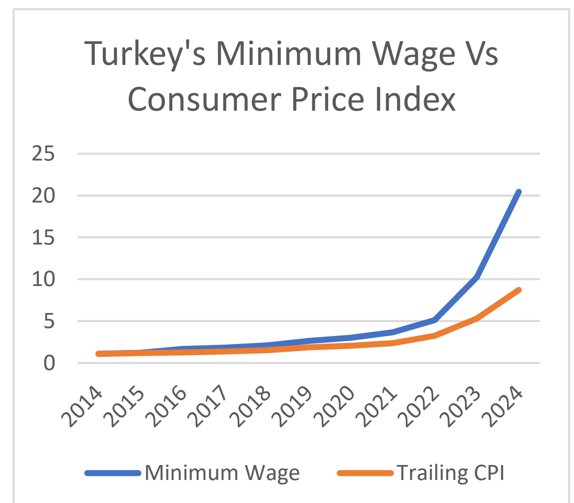
anything meaningful, the result will be a continuation of Turkey's effective national wage inflation policy. That will once again lead to universal wage rises and accordingly, cartel-like pass through to pricing across the economy.

YOY CPI can fall from 75.5% in May to below 50% by August/September.

The continuation of strong inflows into Turkish Lira assets and associated real appreciation of the Turkish Lira is dependent up inflation falling consistently in the coming months. With inflation peaking in May, Turkey should in the coming months see a sharp drop in YOY inflation thanks to the high base effect. Post the June 2023 election, Turkey saw inflationary tax hikes and crucially a 34% rise in the minimum wage in July of 2023 which saw food inflation rising 19% in just two months. With no (or a very low minimum wage hike this July), it is very plausible that inflation will fall to below 50% in Q3. While most economist forecasts are higher than the Central Bank's 2023 full year CPI target of 38%, most expect inflation will fall to the low 40s by year end. With the policy rate at 50% and with some early signs that domestic demand is starting to weaken, it is very possible headline real rates will turn positive in Q3. This will make Turkey's fixed income trade a clear and present opportunity for long absent investors. However, if the government does hike minimum wages again in July, then that opportunity will be delayed or even missed as the Central Bank will likely be required to tighten further before long.

Turkey's structural wage problem not getting enough attention

Why is a decision on minimum wages so important? In today's Turkey, **the** minimum wage is over 80% of average wages vs 32% when Erdogan first came to power (the side chart shows nominal minimum wage growth is up over 20x since 2014 vs inflation up less than half that). Year after year of above inflation minimum wage increases (to improve income distribution) now mean the minimum wage is so high relative to average wages, that this off budget policy choice is the equivalent of an annual national wage growth policy. Minimum wages rose 34% in July 2023, and another 49% in January 2024. This wage pressure has been relentless driver of economy-wide inflation. As virtually every company raised wages at least 49% in January 2024, it is no surprise that even with much higher interest rates (and real currency appreciation), Turkish inflation has continued to run higher than expected by most.



Turkey's cartel-like pricing behavior

In Turkey, when the minimum wage rises, then everyone in the country knows how much everyone's wages have gone up across the economy. This means pricing decisions from the smallest service provider to the largest corporate tend to behave in tandem. The result is a nationwide wage transparency that gives cartel-like pricing power to every company in the country. This is a massive structural driver of inflation stickiness that will need to be broken before Turkey can confidently move from cyclical base-effect driven falls in headline inflation to a more sustainable multi-year dis-inflation trajectory. The consensus of most economists is that the pass through from minimum wages (which is not something that is

traditionally in an economist model), is only about a fifth. This seems a massive understatement reflective of the fact that most economists ignore minimum wages in their models and when they do incorporate them, it is more often an output than an input. However, it is clear wage pass through is a huge problem in Turkey. In the last 12 months, wages have doubled while prices for restaurants, cafes, hotels and residential rents have risen 93% and education is up 105% vs 75% inflation. The pass through from minimum wage hikes for these labor heavy sectors, looks to be almost one for one.

Worrisome we have not heard clearly that there will be no July wage hike

It is unfortunate there has not been clearer messaging on this sooner (it would have been deflationary from the point of announcement, and it would make the wage decisions of individual corporates easier if there was clear political messaging). The latest we should hear is around the 25th of June. It is the single most important economic decision Turkey is facing.

Real minimum wages currently a fifth higher than in December 2023

Since the January wage hike, cumulative inflation in the first half of 2024 is likely to be around 25%. Naturally employees/unions will argue that workers need to be compensated for this loss in purchasing power. However, inflation to date in 2024 is still only half of the 49% January wage hike. The government and employers should counter that workers' wages are still over a fifth higher today in real terms than they were in December of 2023. Additionally with consensus forecasts that inflation will be in the mid-40s in 2024, the 49% wage hike in January of 2024 has compensated employees for all prospective inflation in 2024.

A "modest" July minimum wage hike will telegraph wage growth to all price setters

Even a seemingly "modest" 10% July minimum wage hike (which would bring the 2024 minimum wage growth to 64%), will telegraph to all economic actors that they can re-adjust prices by a similar amount in July/Q3. Better to have no nationwide hike and allow companies to make decisions on wages independently (politically it helps that the job market remains tight). Even if the average company hikes wages by 10%, if done at the micro level rather than by political decree, the informational ambiguity around this will mean there will not be universal understanding of how much wages have risen. This will break the automatic cost push pass through to inflation. If, however, the government announces a minimum wage adjustment of any magnitude, expect every company to follow that figure not just on wages…but largely on pricing as well.

Moving back to once yearly minimum wage hikes will mean CB hikes are over

Even if the government does not want to concede on inflation linked wage hikes, one battle they should be willing to fight is the idea that this adjustment should only happen annually. It is obvious that semi-annual inflation linked minimum wage hikes, that are followed almost universally, reduce the window by half for the Central Bank to reset inflation expectations. All the more so as trailing inflation through May (the last print before this minimum wage decision is made) is at a clear peak that will distort workers perceptions of what they should receive if there is a hike in July instead of December when inflation will be lower. If the government can't make the case to wait until year end for the next minimum wage hike, they will make the Central Bank's job much, much harder.

A minimum wage, if ideally constructed, should represent what is socially considered a living wage that then subsequently rises in line with inflation. In Turkey the elevation of the minimum wage to over 80% of average wages was not a thoughtful social decision that would subsequently allow for automatic cost of living adjustments. It was a repeated populist political decision meant to provide windfalls to the electorate to keep consumption and growth going. If from these levels it is determined that workers always need to be compensated for past inflation, Turkey's only way to break this structural handicap is substantial productivity driven real wage growth that allows the minimum wage to fall as a % of average earnings. That would take many years to play out, if at all. If Turkey is going to deliver dis-inflation without crushing the economy with further rate hikes, it will need a combination of a switch to annual minimum wage adjustments, a move to forward looking wage hikes, some real currency appreciation, and a political commitment to stay the course as consumers feel the pain. To the extent the government wants to alleviate cost of living pain, they will need to do this in a way that does not provide a headline figure for wage growth that everyone can easily understand (tax cuts, subsidies etc.)

Collateral Risk from Inflows into Turkish assets

Continued strong inflows into Turkish Lira assets will cause plenty of challenges from deteriorating export competitiveness to a likely rise in speculative positioning as investors position for what is one of the world's clearest macro trades. Yet imbalances are in their very early stages and the Central Bank, having already started to restrict FX lending growth, appears sensitive to these risks. Although the currency will be strong in real terms, the core of the story is demand driven dis-inflation with significant inflows into TRY assets. As such this is not a time to worry about either the current account deficit, or its funding.

The collision of macro and political risks is only likely to become pronounced when the tension between dis-inflation weakening growth/rising unemployment begins to sway economic policy makers. Thanks to the electoral timetable and the realization that inflation is a political liability, this is unlikely in 2024 and the tension will likely be tolerated though much if not all of 2025.

Why to expect real currency appreciation

Considerable real currency appreciation was squandered over the last year in the name of political rather than economic benefit. In March, there was a sense that currency weakness would follow the local elections as a policy choice, as it did after the Presidential elections in 2023. However the difference in July 2023 was that the country had almost run out of foreign exchange and as yet there was no serious effort to fight inflation (still very early stages with interest rates and they raised the minimum wage 34% just after the vote and they were conditioning the market to not expect an inflation peak for 9 months), so currency weakness to relieve the real currency appreciation (and domestic expectations of devaluation) had benefits but no real cost (beyond the risk that the depreciation became unmanageable)

However, letting the currency weaken now has a real cost of countering the promise that inflation will peak in May as long promised. Simsek and Karahan have referenced a need to have the currency help in their fight against inflation. To see inflation fall, as a minimum the currency cannot fall by more than forward looking inflation. Arguably they need it to

appreciate some in real terms as a currency that weakens as much as inflation only helps to create inflation inertia. If they don't use the currency to help a bit in the inflation fight, then all the pain of fighting inflation will have to be put on workers/consumers via reduced purchasing power. So, from here, every bit of currency strength is politically more palatable (although in time unemployment will rise). While it has economic cost for exporters (and companies that compete with imports), it has the bigger economic gain of helping to bring inflation down which has more net present value for the economy than just providing some temporary currency relief. It helps that the current account is unlikely to create a problem as the consumer and the economy weakens. The negative implications from an uncompetitive currency may manifest themselves in pressure on exports, but it won't create demand imbalance like a strong currency tended to in the past when it aligned with high levels on consumption/imports. All the more so as finally having a positive real rate will make funding any current account fairly easy via fixed income currency flows.

CB Governor Karahan seems to have been thinking about this playbook. He basically allowed the currency to weaken some from assuming the job in January until just before the local elections as that was a period when inflation was rising anyway on the 49% minimum wage adjustment. So, he seemed to be flagging that he would rather front load some currency weakness and then have a bit more liberty for an anchored currency to help with the higher rates in fighting inflation post the local election.

From a 36k foot view, many investors will see positive real rates and no major current account pressure meaning there will be no sense that currency weakness is inevitable (if anything the opposite). Many local investors look at the market in $ terms and wonder if these valuations can be sustained. But so long as there is little fear of a currency correction and a business is well positioned for the macro backdrop, then it is multiples rather than the seemingly inflated $ value of the market (and GDP per capita for that matter) that will drive equity inflows. For the banks which are fairly well positioned for the macro, it should just be an issue of price to book values relative to sustainable ROEs.

Medium term, once inflation is more anchored and it is clear that purchasing power is not there, currency weakness could then be used more liberally (via building up reserves) as it would be less likely to derail inflation as it would now. But even so, the currency was allowed to appreciate too much in real terms (for political reasons) as they let inflation run. If they want to finally get this right, a highly valued currency for quite a while is a cost Turkey largely has to accept. Otherwise, the political window to combat inflation will be missed.

CB Gov Karahan is clearly acknowledging impact of wages on inflation

Cribstone is impressed with the assertiveness of the newish Central Bank Governor Karahan. As detailed in Cribstone's previous update, since Karahan came into office, the inflation report and MPC meeting notes and the Central Bank roadshow presentation (used in Qatar in mid-May), have mentioned wages and minimum wages as a driver of Turkey's inflation pressures more than a dozen times. Indeed, On April 5th, the Central Bank released the letter it is legally required to publish when it misses inflation forecasts (always). In the letter there was an unprecedented explicit reference to wage pressures as part of the problem. In

total there are four references to wages in the letter, **including an explicit mention that achieving inflation objectives requires that the minimum wage only be raised once a year**.

This seeming independence is arguably because his Fed & Amazon pedigree means he has a lot to lose in terms of career opportunity should he fail, or be perceived as a facilitator of populist policies as was the case with most previous Central Bank Governors. This aligns his decisions with investors more than any of his predecessors in recent years.

Market Outlook with weaker Demand

Assuming no minimum wage hike, dis-inflation will be driven by a weakening consumer whose purchasing power, which has driven the higher-than-expected inflation through May, will erode to year end. Every company has pricing power when wage hikes are universally known. Yet if the cycle of minimum wage hikes is ended, be cautious of businesses without differentiated pricing power as they will find that much of their pass through in recent years was macro driven. Caution remains justified for all companies that are highly interest rate sensitive. However, to the extent minimum wage policy solidifies the dis-inflation story, interest rate cuts will become part of the narrative as we head towards 2025. Real currency appreciation argues to remain cautious about exporters and those competing with imports. Yet some relief will be provided if wages become less of a challenge.

Even if there is no minimum wage hike in July, there will be pressure on many companies to raise wages in July. The labor market is still very tight and trailing inflation is high which leaves many workers struggling with the cost of living. For domestic focused companies whose profits are high, expect some July wage adjustments (exporters and any facing clear margin or demand pressures are unlikely to raise wages if not forced by a minimum wage hike). These sorts of company level wage adjustments are unlikely to disrupt the overall dis-inflation story as it will be varied, selective and opaque. However, do expect that it will likely have an impact on profit margins for those specific companies as it is likely to soon be followed by overall demand weakness. Also, with no wage hikes and workers taking the brunt of the dis-inflation pain, there may be some potential for strikes in the latter half of the year as wage restraint and a still tight labor market overlap.

Equities no longer an inflation hedged winner, be selective

Turkish equities have had a tremendous period of performance for a number of years. Yet this is largely because inflation has been so ubiquitous that virtually every company in Turkey had the ability to pass inflation on to their customers. This “inflation hedged” status of equities, combined with financial repression on traditional alternative investments (fixed income, deposits, and the $), meant that equities were one of the few liquid stores of value (housing also did tremendously well although it now is showing some strain). The resulting equity bull market led to huge numbers of small, domestically focused IPOs which almost universally soared in the aftermarket. With millions of new retail investors in the market, IPOs have become one of the few economic bright spots with positive electoral implications for the government. However, on a few counts this near perfect backdrop for retail enthusiasm for the market looks to be on its last legs.

1. As wage policy turns deflationary, many companies will learn that their “pricing power” was really just macro-wide inflation pass through. Deflation will break the cycle of earnings delivery for many businesses exposing them to be lower

quality than perceived. For many an inability to pass on costs will hit margins. With mixed earnings delivery, the equity market will no longer be a one-way store of value for retail investors

2. Retail investors will have plenty more investment options to choose from. Deposit and fixed income rates, especially as inflation finally begins to fall, will simply be much more attractive. And if inflation doesn't fall and the government continues to stimulate, in due course the likelihood is that investors in the USD will be well rewarded. Financial repression is no longer driving retail investors to equities
3. It is likely a large number of retail investors were only in the market because it was easy money, especially with IPOs. The end of the equity monopoly as in inflation hedge is likely to lead to not just earnings disappointment, but perhaps also a risk of de-rating for stocks that aren't capable of attracting larger institutional and foreign money.