Turkey: Pay 5Y cross-currency swap rates

EM Fixed Income Strategy

Long-dated rates will sell off more, in our view. The central bank is struggling to contain inflationary pressures with its policy mix and is likely to maintain tight lira liquidity and high short-term rates over the next few months. The yield curve is inverted and the long-dated rates are low by historical standards, especially given that year-on-year inflation has surged and is likely to remain elevated in the next four to five months. Persistently high funding rates will translate, in our view, to higher long-term swap rates. While we think the trade will work even in a risk-on environment, it is possible that stability in global markets might take pressure off the lira and result in a relief rally in fixed income markets.

We prefer paying cross-currency swap rates in the more liquid five-year sector of the curve. We recommend hedging FX exposure with six-month forwards to lock in the carry. The indicative level on the five-year swap is 7.72%. The implied yield on the six-month forward is about 9.9% (reference USDTRY rate of 1.9735, six-month forward points are 880). Because of the inversion of the yield curve, the carry is positive, which is unusual for payers. We target 8.2% on the five-year rates (i.e., a 50 bps sell-off) and we set a stop-loss at 7.40%, about 30 bps below the current level.

Exhibit 1: Despite Central Bank’s efforts, TRY is trading weak

Exhibit 2: Long-dated TRY rates are low by historical standards and given rising inflation

YoY CPI Inflation. December 2011 point was 10.45%
2-year and 10-year cross-currency rates

Source: Haver Analytics, Credit Suisse
Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse
Turkish rates to sell-off further

The central bank has achieved only limited success in correcting external imbalances. The central bank launched its unconventional monetary policy about a year ago with the dual goal of slowing domestic demand (by restricting credit growth) and weakening the lira (by keeping relatively low interest rates) while at the same time maintaining price stability. The central bank has registered some success in slowing domestic demand growth, which will likely continue slowing this year. Unfortunately, external demand - mainly from Europe – will likely remain sluggish, rendering only a marginal improvement in the current account deficit (10.3% of GDP projected for 2011 vs. 8.9% of GDP forecast for 2012), despite the weaker lira and slower domestic demand growth.

The central bank is concerned about the lira’s weak exchange rate. The lira weakened between April and August of last year as a result of the central bank’s unconventional monetary policy approach and Turkey’s large current account deficit, underperforming its peers as shown in Exhibit 1. The central bank cut the policy rate (seven-day repo rate) to 5.75% on 4 August in response to slowing growth indicators across the globe, just before the onset of the broader market sell-off. Even though the lira has outperformed most EMEA and Latam currencies since August, it has weakened by about 20% against the basket since the beginning of 2011. Between early August and late October, the central bank introduced a number of measures to limit the depreciation pressure on the lira, including sizeable FX sales via auctions, with only limited success. Concerned by possible second-round effects of lira depreciation, the central bank introduced liquidity-tightening measures on 20 October. Since 29 December, it has tightened lira liquidity further and sold sizable amounts of FX (both through FX auctions and direct interventions), giving the impression to the market participants that it is defending the 2.20 level against the basket.1

The central bank is keeping lira liquidity tight, which puts upward pressure on short-term rates. On 20 October, the central bank hiked the upper end of the short-term interest corridor by 350 bps to 12.5%, while it kept the lower-end of the corridor unchanged at 5.0% and the policy rate unchanged at 5.75%. The central bank announced its liquidity provision framework on 28 December (see our breaking news note for details). In the four weeks following the announcement, the central bank will decide whether a trading day is “normal” or “exceptional”. On normal days, the bank will provide liquidity (between TRY 3bn and 7bn) at the 5.75% policy rate. On exceptional days, the central bank will still hold the one-week repo auction, but it will be cleared at market price, rather than at the policy rate. All trading days since 28 December were classified as exceptional. In practice, short-term rates have jumped higher since mid-October, and increased further in the last few days, as shown in Exhibit 3.

High funding rates will translate into higher long-term rates, in our view. We think the central bank will maintain tight lira liquidity in the next few months, as depreciation pressure on the lira is not easing. Anecdotal evidence suggests that corporate demand for dollars remains high. The current account deficit remains large although it will likely narrow in the coming period. In the meantime, inflation data have been surprising on the upside. There is little doubt that the weakness of the lira is an important contributor to high inflation. Year-on-year inflation should drift lower in the second half of this year because of the base effects, provided that the central bank’s tightening measures turn out to be successful in containing the depreciation pressure on the lira. However, the year-on-year inflation will likely remain elevated in the next four to five months. On balance, the central bank’s

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1 1/2 (TRY/USD + TRY/EUR)
2 Market rates are unlikely, under the current policy framework, to exceed this limit because the central bank is providing virtually unlimited liquidity to market-makers at this rate.
tolerance for further weakening of the lira should be low, resulting in tight lira liquidity over the next few months. The yield curve is very inverted (Exhibit 4), and we believe that persistently high carry would translate into higher long-dated rates and a steeper curve over the next few months.

The risk to this view is that the depreciation pressure on the lira would go away in a more constructive global environment, paving the way for the Turkish central bank to ease short-term interest rates. We doubt, however, that investors will rush to receive long-dated Turkish rates in such a bullish global scenario. The yield levels are not particularly attractive by historical standards. Short-dated rates would likely fall back toward the lower bound. But long-dated rates will probably be correlated with global rates (see Exhibit 5), which would be under pressure in a risk-on scenario. Conversely, resumption of volatility in global markets is likely to put pressure both on the lira and the yield curve, benefiting the trade.

Exhibit 3: Short-dates rates have jumped higher since October

(5) one-month implied FX yield.

Exhibit 4: The xccy curve is sharply inverted

5y – 1y cross-currency swap rate

Source: Credit Suisse

Exhibit 5: Turkish and global rates are correlated

5-year xccy swap in Turkey and 5-year USD swap rate (RHS)

Source: Credit Suisse Locus
# Emerging Markets Economics and Fixed Income Strategy

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Investment principal on bonds can be eroded depending on sale price or market price. In addition, there are bonds on which investment principal can be eroded due to changes in redemption amounts. Care is required when investing in such instruments. When you purchase non-listed Japanese fixed income securities (Japanese government bonds, Japanese municipal bonds, Japanese government guaranteed bonds, Japanese corporate bonds) from CS as a seller, you will be requested to pay purchase price only.