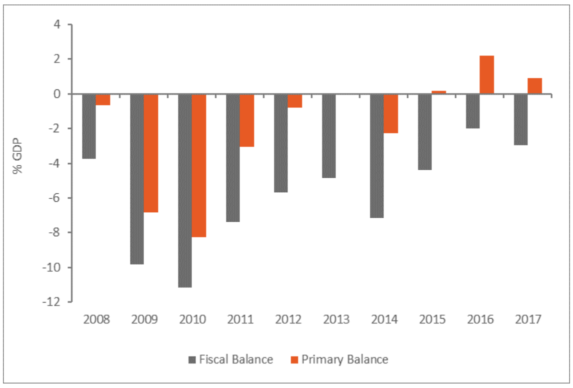
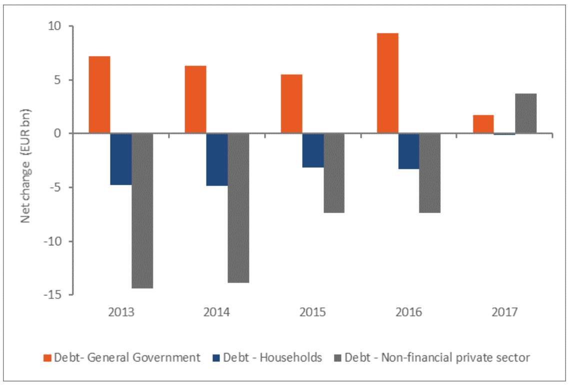
Fiscal measures for 2017 reflect fiscal consolidation efforts, Novo Banco remains financial sector stress factor

- Fiscal deficit for 2017 reported at 3% of GDP (including CGD capital injection), public debt ratio was measured at 125.7%
- Novo Banco reports record losses in 2017, resolution fund will have to inject EUR 792 mn
- Beneficiary financing conditions in primary and secondary market endure
- Italian risk premium over Portuguese 10 Y yields estimated to fall in the medium term

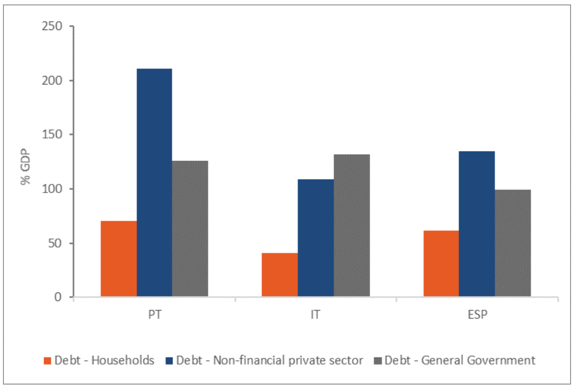
Macroeconomics – March



Source: INE, BiG Research



Source: Banco de Portugal, BiG Research



Source: Banco de Portugal, Trading Economics, BiG Research

Historically low fiscal deficit (if excluding CGD capital injection)

Portugal's budget deficit for 2017 was measured at 3% of GDP, finally including the effect of the Caixa Geral de Dépositos (CGD) capital injection of EUR 3.9 bn in March last year. Without the effect of the CGD capital transfer (corresponding to 2% of GDP and controversially discussed if to be accounted for in the state budget), the fiscal deficit stood at 0.92% of GDP – the lowest value measured in the democratic history of Portugal.

No structural changes on expenditure side

Beneficiary economic conditions (higher income tax receipts, lower social spending, lower interest rate payments, denominator effect) facilitated fiscal consolidation rather than actual improvements on the expenditure side. The budget deficit widened by EUR 2 bn, general government expenditures increased by 6.2% in comparison to last year and at a faster pace than revenues (3.9%). Positive is the increase in general government gross fixed capital formation of 25%, however still remaining 50% below its pre-crisis level.

Public debt ratio drops to 125.7% of GDP in 2017 (130.1% in 2016)

Net borrowing has accumulated to EUR 5.7 bn in 2017, corresponding to 125.7% of GDP (129.9% in 2016) and therefore strictly following Portugal's downward trajectory in public debt - again despite its annual nominal increase (+ EUR 1.7 bn). Considering the total economy, only households succeeded to reduce their indebtedness in nominal terms, if only slightly and to a much smaller scope than in the precious years. Past deleveraging efforts in the non-financial sector were put at halt in 2017, as large corporations utilized current beneficiary financing conditions to issue additional corporate debt.

Non-financial private sector indebtedness exceeds periphery peer

Non-financial private sector indebtedness stood at 73.5% of GDP in Portugal, significantly exceeding its periphery peers. Corporate indebtedness profiles can primarily be found among small to medium-sized corporations (SME) - accumulating debt levels close to EUR 160 bn (81% of GDP) – and predominantly active in the construction and real estate sector.

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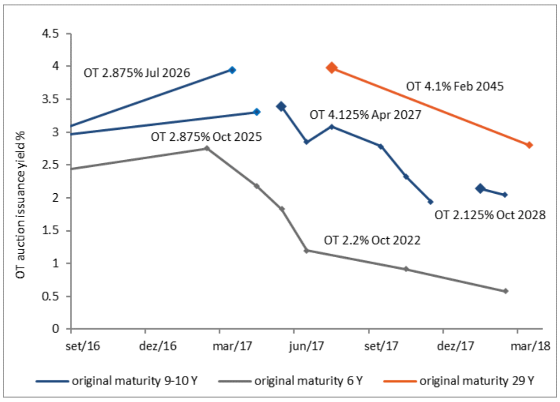
Primary Market - March

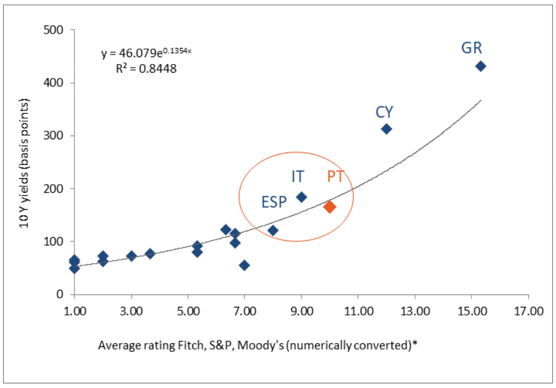


Source: IGCP, BiG Research

Supportive financing conditions endure

In March, the OT line *Feb 2045* (residual maturity of 27 years) was auctioned at an issuance yield of 2.8%, 110 bps lower than in its last auction end of last year (3.977%). The issuance yields of a treasury bill auction (6 & 12 months maturity) have remained largely unchanged in negative territory (-0.424% and -0.394% respectively). Since beginning of this year, Portugal has issued government bonds and treasury bills worth total EUR 2.5 bn and EUR 4.1 bn respectively. The state targets additional financing of EUR 8.3 bn through the issuance of OTs & BTs and EUR 1.8 bn through retail debt by the end of 2018 (IGCP, March 2018)

Secondary Market - March

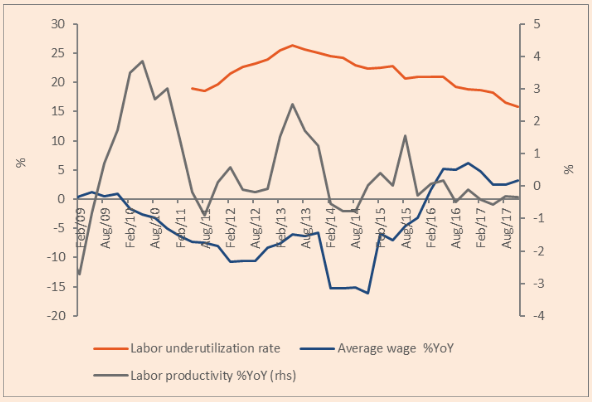


Source: Reuters, BiG Research
Average value of numerically converted credit rating grades, "AAA"= 1, "D" =24 for all Eurozone countries, data retrieved on 29.03.2018

Italian risk premium against Portugal to fall in the medium term

Portuguese 10 Y yields have fallen by 30 bps to a level of 160 bps in March, after reaching the psychological benchmark of 2% beginning of this year. Vis-à-vis Germany, Portuguese 10 Y yields have compressed further by more than 15 bps. The Portuguese 10s30s spread has compressed by 10 bps, the 2s10s spread by 15 bps. Italian 10 Y yields have continued trading above Portugal's, reaching a record negative spread of -22 bps in March - as negative as last seen in 2009. We still estimate considerable value on the Italian 10 Y yields (-28 bps bps) vs. the regresion model estimates the Portuguese 10 Y yields at +14 bps above their current yield levels.

Monthly Spotlight: Development of Portuguese wage levels



Source: OECD, INE, BiG Research
*measured in labor productivity per hours worked (2016), Eurostat

Largely unchanged labor market structure limits wage growth

The strong recovery in the Portuguese labor market (drop of unemployment rate from 11.1% in 2016 to 8.9% in 2017) has translated into first increases in wage levels in 2017. Average real wages (industry, construction and services) have increased by 2.4% in 2017 (-0.4% in 2016). The large share of underemployment as much as the enduring large share of precarious employment (same share of temporary employment of 18.5% in 2017 as in 2015) however remain limiting factors for a faster translation of the recovery in labor market into higher wages, and therefore higher inflation rates - symptomatic for the whole Eurozone. An additional factor in play for the Portuguese case is its enduring low productivity (46% inferior of Germany's labor productivity*).

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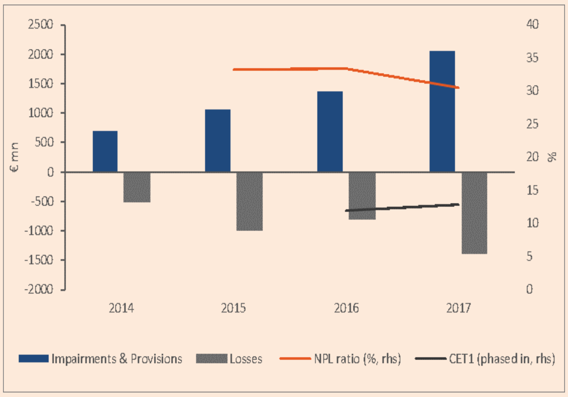
Financials - Novo Banco



Source: Novo Banco, BiG Research
* European Banking Authority Q2 2017

Record net losses in 2017, resolution fund needs to step in

Novo Banco has accumulated a record net loss of EUR 1.4 bn in 2017, primarily due to increases in impairments. For the bank to maintain its capital ratio (*CET 1 ratio*) of 12.8% as measured by the end of 2017, the bank will have to receive total EUR 791.7 bn from the resolution fund (of which EUR 350 mn will be covered by all Portuguese banks' contributions to the fund and EUR 450mn by a state loan). Irrespective, Novo Banco succeeded to decrease its operational costs by 7.1% last year, its non-performing loan (NPL) ratio was lowered by 2.9 percentage points to 30.5% and its coverage ratio increased by 9.4 p.p. to 58.7% (vs. national average of 17.6% and 44.9% respectively*).

Outlook – April

ECB Governing Council Meeting:

We do not expect the ECB to disclose new information on its QE exit plan in its meeting in April yet, much rather implying the official kickstart for extensive exit strategy discussions amongst hawks and doves. The economic and inflationary development for the Eurozone has meanwhile remained unchanged: Inflation levels remain shy from the 2% stability target, the PMI index appears to have reached its highest level around the turn of the year. We expect the ECB to disclose its exit strategy only in the upcoming Council Meeting in June. We expect the ECB to announce a gradual QE exit strategy, with its monthly asset purchases to fade out gradually until the end of this year. We do not rule out the possibility of a first rate hike within the first half of 2019.

Event Outlook - April

Date	Event
3-Apr	Unemployment rate (Feb)
9-Apr	Global Trade Balance (Feb)
11-Apr	CPI Inflation (Mar)
18-Apr	Current Account Balance (Feb)
26-Apr	ECB Governing Council Meeting
27-Apr	Business Confidence (Mar)
27-Apr	Consumer Confidence (Mar)
30-Apr	Unemployment rate (Mar)

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MACROECONOMIC DEVELOPMENT				BiG Research	Forecasts 2018	
					IMF**	Ministry of Finance
	2015	2016	2017	Development 2018	2018 P	2018 P
Real Economy (YoY, % change)						
GDP	1.8	1.6	2.7	→	2.0	2.2
Private Consumption	2.1	2.1	2.3	→	1.8	1.9
Public Consumption	1.3	0.6	0.1	↓	0.5	-0.6
Investment (GFCF)	6.4	0.8	8.5	↑	5.7	5.9
Imports	6.1	4.4	7.8	→	5.2	5.2
Exports	8.5	4.2	7.9	→	5.1	5.4
Fiscal Account (%GDP)						
Primary balance	0.2	2.2		↑	2.7	2.7
Budget balance	-4.4	-2.0		↑	-1.4	-1.0
Public debt	128.8	130.2		↑	122.5	123.5
External Accounts (%GDP)						
Current Account	0.1	0.6	0.5	→	0.5	0.1
NIIP	-113.2	-106.1	-105.7	→		
Gross External Debt	222.0	215.3	211.0	→		
Labour market (YoY, %change)						
Unemployment Rate	12.4	11.1	8.9	→	9.0	8.6
ULC	0.9	2.6	1.4	↓		
Labor Productivity	0.4	-0.1	-0.4	↓		
Sentiment Indicators						
Consumer Confidence Indicator	-12.6	-11.7	-0.1	↑		
Industrial Confidence Indicator	-1.2	-0.9	2.3	↑		
Financial Sector						
Tier 1 Ratio	11.3	11.5		↑		
Return on Equity	0.5	-3.2		↑		
Share of NPLs (NFC; % of total loans)	16.0	16.1	15.0	↑		
Monetary/FX						
Inflation, HICP (YoY, % change)	0.50	0.64	1.55	→		
PGB 10Y-Bund Spread (Bps)	180.3	322.8	241.9	↑		
EUR/USD	1.11	1.10	1.15	→		
Real effective exchange rate (1999=100)	87.0	89.2	90.5	→		

Source: INE, Banco de Portugal, ECB, Reuters, DG ECFIN, OECD

*Full-year data 2017 already available, no projection

**IMF Article IV country report projections, ***Ministry of Finance projections as accounted for/published in the State Budget 2018

Cross-Country Bund Spreads

Bps	France	Spain	Italy	Portugal	Greece
2y	13	25.9	34.8	38.9	203.2
5y	7.4	28.3	79.5	70.4	357.1
10y	23.5	71.5	134.4	115.1	386.6
30y	43	105.5	176.2	147.7	678.3
Δ 1M					
2y	3	-4.8	-7.3	-11.8	6.5
5y	-0.6	-13.4	-9.1	-18	-5.5
10y	-3.2	-16	-6.2	-17.6	11.7
30y	0.7	-18.3	-1	-28.8	16.6

Source: Reuters, data retrieved on 29.03.2018

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