MACRO RESEARCH - PORTUGAL

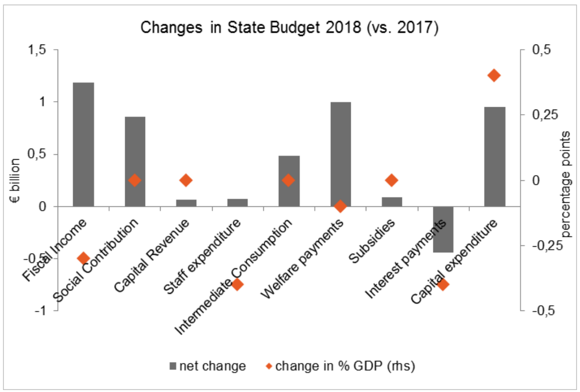
MONTHLY BULLETIN

NOVEMBER

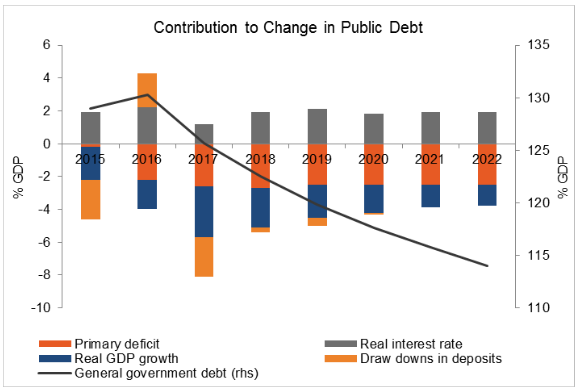
Markets steadily regain confidence in Portugal, considerably smooth consensus finding on the state budget

- The State Budget for 2018 keeps Portugal in line with EU budget rules. Spending will to large parts be based on (cyclical) economic growth, while structural changes on the expenditure side have failed to be addressed.
- The QE tapering as from 2018 will allow Portugal to prove its financial market and economic resilience under receding ECB support.
- The IMF Article IV country report strikes a generally optimistic but also warning balance with regards to the Portuguese economic recovery, addressing its structural limits on long-term GDP growth.

Macroeconomics - October



Source: Ministry of Finance, BiG Research



Source: IMF

State Budget for 2018: Non-structural fiscal consolidation

An unexpected strong economic recovery as well as cyclical income sources, larger dividend payments of Banco de Portugal and reduced interest payments allow the state to increase its total spending by € 2.5 billion in comparison to 2017 while steadily meeting EU budget rules – targeting a debt/GDP ratio of 123.5% and a deficit of 1% by the end of 2018. Public investment (GFCF) is planned to increase to 2.3% of GDP next year (1.7% in 2017) - still remaining one of the lowest GDP shares in the last two decades. Public staff costs will increase in nominal terms. Freezing of spending withholdings (*cativações*) will likely accumulate to € 1.8 billion next year, similar to 2017.

Nominal debt stock likely to increase further (IMF projections)

The public debt weight (% GDP) is expected to decrease over the next five years, whereas in nominal terms to increase to € 246 billion by the end of 2018 (€ 20 billion more than in 2014). Real GDP growth and fiscal policy are estimated as the largest contributors to Portugal's descending debt weight trajectory over the next five years. A moderate reduction in Portugal's considerably large cash buffer (currently ensuring half of the state's financing for the next 12 months) is further likely to support state debt reduction. Nevertheless, structural deficit is expected to gradually worsen over the next five years.

QE tapering announcement – Robustness test for Portugese debt market

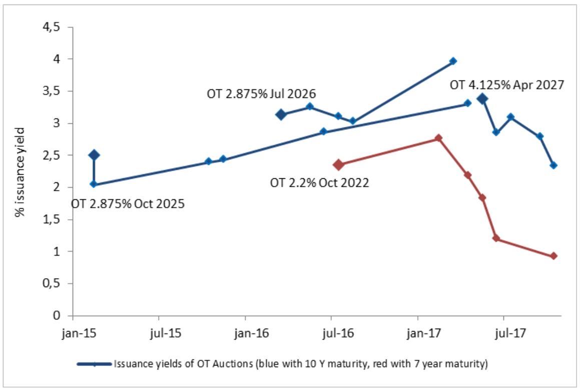
The ECB will halve its monthly asset purchases from currently € 60 billion to € 30 billion as from January 2018 for 9 months, with its end to remain open and reserving for itself to increase purchases in terms of size and duration – if necessary. The forward guidance for interest rates remained unchanged.

- We expect a comparably less pronounced tapering effect on Portuguese yields than for the rest of the peripherals, as current yield levels of Portugal should already discount for receding ECB support. Monthly purchases of Portuguese bonds have remained well below their capital-key implied purchase volumes (-60% so far this year).
- We expect the 10 Y Portuguese Bund spread to moderately continue compressing along the year, due to the re-anchoring of inflation expectations on the Bund yields alone.
- As much as financing conditions are primarily anchored at the ECB interest rates - which should not be lifted before September next year – Portugal needs to address its ongoing decline in the bank lending to the corporate sector.

Analysts:
Annika Hofmann
annika.hofmann@big.pt

João Lampreia
joao.lampreia@big.pt

Primary Market - October

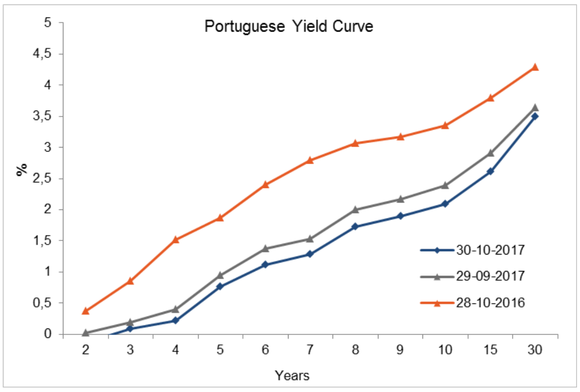


Source: IGCP, BiG Research

Low funding costs incentivize further bond issuance

Financing through treasuries has been revised upward in October (as originally still outlined in June) due to ongoing supportive financing conditions. Sovereign bonds worth € 9.14 billion have been issued so far this year (already exceeding the annual funding volume of € 8.98 billion in 2016), including the October auction of two bond lines (*Oct 2022, Apr 2027*) worth € 1.25 billion. Portugal has further settled additional € 1 billion of early IMF debt repayments, with two more billions to follow by the end of the year (making it a total repayment of € 8.4 billion in 2017, € 4 billion more than last year). State funding worth € 3.2 billion is still outstanding till the end of the year.

Secondary Market - October

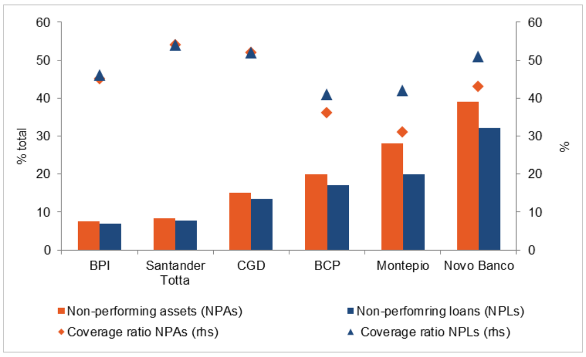


Source: Reuters

Portuguese 10 Y yields reaching 2 %

10Y Portuguese yields have reached its year-low rate of 2 % by the end of October, a yield level as low as last seen in 2015. The 2s10s spread has further flattened by 17 bps last month, the10s30s spread steepened by more than 10 bps but is expected to also slightly flatten along the year as we also expect a downward movement in the 30Y yields with the entrance of large bond indexes (e.g. pension funds) under our base scenario of a second *investment grading* by Fitch in December. Portuguese 10Y yields further compressed vis-à-vis Germany by almost -20 bps.

Financial Sector - Banking Performance



Source: Moody's "Issuer in-depth" banking analysis, Sept 20th 2017

New ECB regulation to further induce NPL reduction

Portugal´s NPL ratio of 17.6% by far exceeds the EU average of 4.5% (Italy 12%).[1] Concerning is further Portugal´s ratio of non-performing exposure of 15% - almost four times as large as EU average. As from 2018, the ECB will introduce a new NPL regulation in order to ensure sufficient coverage for banks' non-performing exposure, it might however lead to temporary restrictions in the financial intermediation. Banks will have to provide 100% of the loans that are newly considered non-performing (following EBA definition) within two years for the unsecured portion and seven years for the secured portion.

[1] Following the European Banking Authority (EBA) definition, applying a more stringent definition of non-performing assets than under the Banco de Portugal regulation. Data retrieved from EBA dashboard Q2 2017.

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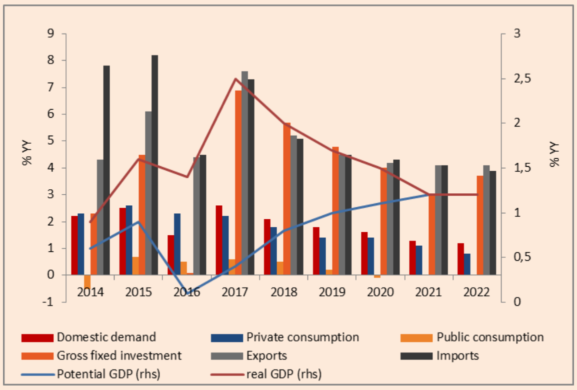
joao.lampreia@big.pt

IMF Projections 2017 – 2022



Source: IMF Article IV Country Staff Report

Structural limitation on potential GDP remain in place

Potential GDP growth is forecasted to stabilize around 1.2% in the medium term. Low profitability (while expected increasing labor costs), unaltered high public and private indebtedness as well as a still recovering and low-profitable financial sector will remain Portugal´s limiting growth factors in the medium to long run.

Domestic demand will likely remain the backbone of the economic recovery, net export growth contribution will likely remain nil. Tourism will further affirm its economic importance over the next years. Public consumption will likely remain a negligible factor.

Outlook – November

Catalan Referendum - domestic tension to decelerate until elections

The seriousness of the Catalonia independence movement reached a new high with the dismissal of the regional government by Madrid after the parliament of Catalonia declared independence on October 27th. With the pro - independence parties agreeing on regional elections scheduled for December 21 - rather than encouraging for street protests and civil disobedience - , the situation could relax slightly at least for the upcoming month – ceteris paribus. So far, the situation in Spain has not been classified as a systemic (Eurozone) risk by the markets.

Event Outlook - November

Date	Event
08-nov	Unemployment rate (quarterly)
09-nov	Global trade balance (m)
13-nov	CPI (MM YY)
14-nov	GDP growth (QQ YY)
15-nov	Reopening 6m & Launch 12 m BTs
20-nov	Currrent account balance (m)
29-nov	Business & Consumer Confidence (m)

Source: Statistics Portugal (INE), Banco de Portugal

Third Quarter - Data Publication

- **GDP growth rate**

The GDP growth rate for the second quarter has subsequently been revised upward to 3% (preliminary 2.9%), making GDP growth in the first half of the year reach 2.9%. We do not expect large differences in the growth development in the third quarter, with its growth contribution primarily to emanate from domestic demand, and export and import to continue growing at equal pace. The growth momentum from tourism will likely decelerate in the last quarter of the year due to seasonal factors. Annual growth rate estimates vary around 2.5% (2018 State Budget Report 2.6%, Banco de Portugal and IMF 2.5%, Portuguese Public Finance Council 2.7%).

- **Unemployment rate**

The pre-crisis level unemployment rate of 8.8% in the second quarter strongly benefited from new jobs created in the service sector. We anticipate similar conditions in the third quarter. Our focus will specifically be laid on the analysis of long-term unemployment as well as wage growth vis-à-vis productivity.

Treasury and Debt Management - IGCP activity

- Nov 15th: Auction of 6 months (reopening) & 12 months (launch) BTs, indicative amount set between € 1.25 and € 1.5 billion
- Nov 17th: Amortization of BTs worth € 2 billion, last amortization payment this year (for both BTs and OTs)

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MACROECONOMIC DEVELOPMENT						BiG Assessment Development 2017	Forecasts*** IMF	Minstry of Finance	
	2014	2015	2016	Q1 2017	Q2 2017		2017 P	2017 P	2018 P
Real Economy (YoY, % change)									
GDP	0,9	1,8	1,5	2,8	3,0	↑	2,5	2,6	2,2
Private Consumption	2,3	2,1	2,1	2,7	2,6	→	2,2	2,2	1,9
Public Consumption	-0,5	1,3	0,6	-0,3	-0,6	↓	0,6	-0,2	-0,6
Investment (GFCF)	5,1	6,4	0,9	7,9	9,3	↑	6,9	7,7	5,9
Imports	7,8	8,5	4,1	9,1	7,0	↑	7,6	8,0	5,2
Exports	4,3	6,1	4,1	9,7	8,1	↑	7,3	8,3	5,4
Fiscal Account (%GDP)									
Primary balance	-2,3	0,2	2,2	2,2*	1,6*	↑	2,6	2,5	2,7
Budget balance	-7,2	-4,4	-2,0	-1,6*	-2,1*	→	-1,5	-1,4	-1,0
Public debt	130,6	128,8	130,2	128,3*	129,8*	→	125,7	126,7	123,5
External Accounts (%GDP)									
Current Account	0,1	0,1	0,7	0,70**	0,15**	→	0,6	-0,1	0,1
NIIP	-117,5	-112,0	-104,7	-102,2	-103,3	→			
Gross External Debt	236,5	222,5	215,4	212,1	212,0	→			
Labour market (YoY, %change)									
Unemployment Rate	13,9	12,4	11,1	10,1	8,8	↑	9,7	9,2	8,6
ULC	-0,6	0,8	2,1	1,1	0,9				
Labor Productivity	-0,5	0,2	-0,2	0,6	0,5	↑			
Sentiment Indicators									
Consumer Confidence Indicator	-19,6	-12,0	-11,6	1,2	1,5	↑			
Industrial Confidence Indicator	-4,3	-1,2	-0,9	2,4	1,3	↑			
Financial Sector									
Tier 1 Ratio	10,5	11,3	11,5	12,7	-				
Return on Equity	-18,1	0,5	-3,2	-0,1	-				
Share of NPLs (NFC; % of total loans)	14,6	15,9	16,0	15,5	15,2	→			
Monetary/FX									
Inflation, HICP (YoY, % change)	-0,15	0,50	0,64	1,42	1,72	↑			
PGB 10Y-Bund Spread (Bps)	248,0	201,1	318,5	377,3	322,3	↑			
EUR/USD	1,3	1,10	1,09	1,07	1,09				
Real effective exchange rate (1999=100)	95,4	87,0	89,3	88,1	89,1				

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

*quarterly data available used for calender year projection, **seasonally adjusted,

*** 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	18,1	40,6	54,6	61,6	392,3
5y	19,9	58,6	96,5	112,3	491,5
10y	40	113,6	148,4	172,3	521,5
30y	51,7	153,6	178,6	224,5	692,9
Δ - 1M					
2y	6,7	1,4	0,8	-9,1	10,9
5y	-7,5	4,3	-13,8	-9	-4,2
10y	11,3	-1,8	-23,4	-20,1	0,7
30y	-7,6	-6,3	-23,5	-15	24,5

Source: Reuters, retrieved on October 31st, 2017

Analysts:
Annika Hofmann
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