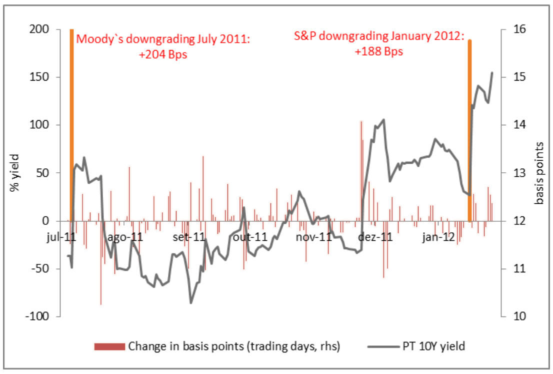
Portugal reaps rewards and recollects investment-grading

- The S&P reissuance of *Investment Grade* marks an important landmark in the recovery path of the Portuguese economy.
- Local elections results acknowledge the political course of Costa, strengthening PS´s position in the state budget negotiations.
- Novo Banco sale can move forward to conclude as bondholders agree on necessary bond buybacks.

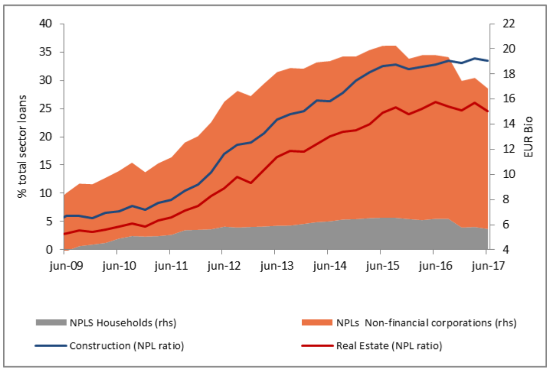
Macroeconomics - September



Source: Reuters, BiG Research

S&P Re-issuance of *Investment Grade* after more than 5 years

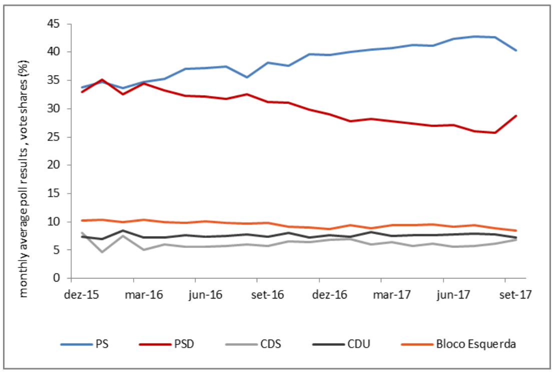
S&P decision to lift Portugal back to investment grade last month took markets by surprise, the 10Y yield dropped by more than 35 basis points within one trading day. For Portugal to re-enter the broad sovereign bond market it will however be essential to fulfill large bond indexes´ requests of holding *Investment Grade* by two major agencies - under our base scenario to be materialized through the Fitch upgrade in December this year. The agencies´ bond downgrading to "junk" status 5 years ago triggered considerably strong, persistent yield movements.



Source: Banco de Portugal

Creation of NPL enhanced coordination platform

Novo Banco, CGD and Millenium BCP have created a platform (ACE) in order to manage and accelerate the recovering of NPLs.[1] Private loans worth minimum € 5 million qualify for the process, with the bad credit to remain in the banks´ balance sheets. The addressing of one of Portugal´s most imminent (financial sector) problems sends a positive signal, the concept´s effectiveness is however expected to remain limited. The Portuguese banking sector contains NPLs with an estimated amount of € 30 billion. Loans to the corporate sector, in specific for the construction and real estate sector, are most vulnerable.



Source: marktest.com

PS strengthens its political power in local elections

PS was able to consolidate its political position at half-time of the legislative period, receiving 38% of votes at the local elections. Election results are expected to reinforce the PS position in ongoing state budget negotiations as well as increase the probability for the minority government to survive the full four-year term. Since taking office in November 2015, PS has significantly gained vote shares (to large parts from PSD). Costa´s political course has not least been benefiting from favorable economic developments. Pedro Passos Coelhos took responsibility for the electoral defeat and stepped down as PSD party leader.

[1]The platform has been created in form of an ACE (Agrupamento complementar de empresas). The three participating banks hold the sector´s largest shares of NPLs (Novo Banco € 4.5 billion CGD € 4 billion, BCP € 3 billion). The fund is non-exclusive, participation is voluntary.

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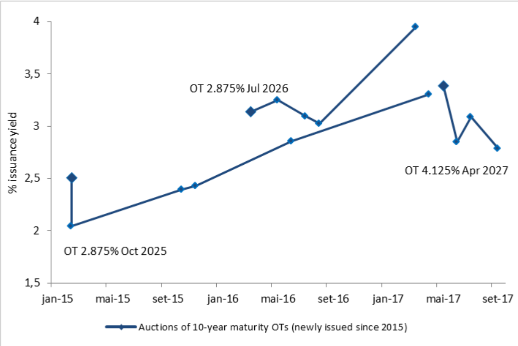
Primary Market - September

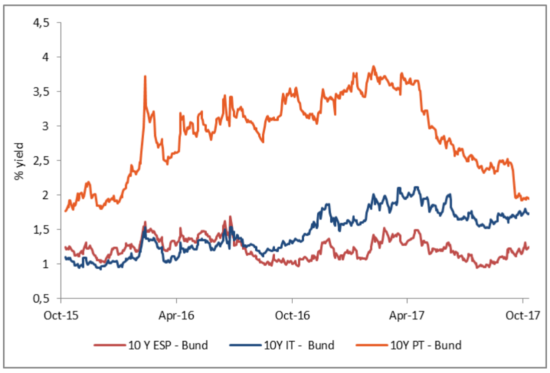


Source: IGCP

Reduced cost of debt issuance, debut of panda bond

The 2017 newly issued 10 year maturity bond line (Apr 2027) has introduced a receding trend in issuance yields. Last month´s auction reached the lowest issuance rate since end of 2015 (2.785%) as well as the highest bid-to-cover ratio so far this year (2.06). Further, Portugal announced to become the first Eurozone country issuing a Panda bond on the Chinese interbank bond market. The issuance of the debut bond with a maturity up to 5 years and a first drawdown amount of €380 million is expected to conclude end of this year.

Secondary Market - September

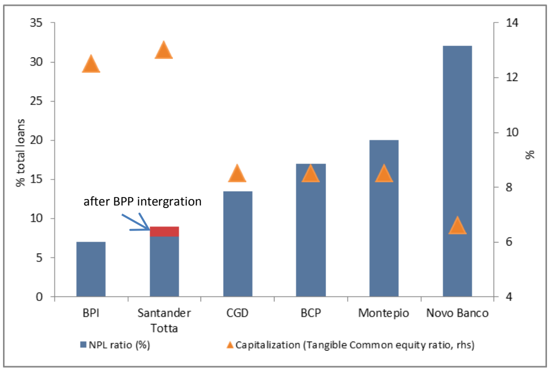


Source: Reuters

Significant spread compression due to S&P rating decision

The Portuguese bund spread compressed by more than 50 basis points last month. The Portuguese 10Y yield rate dropped from 2.8% to 2.4% alone due to the S&P reissuance of investment grading - capturing almost half of the downward yield movement since reaching its year-high in March. The spread between Portugal and Italy dropped to year-low 30 bps (versus 220 bps in September 2016), expecting to compress, or even reaching at par, further this year. The 10 Y Portuguese yields have followed a rally against Spanish yields from 260 bps beginning of this year to 80 bps last month.

Financial Sector - Banking Performance



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

Varying improvements in credit profiles, legacy issues remain

The Portuguese banking system depicts strong heterogeneous performance with regards to asset risk and capitalization. Santander Totta and BPI have made considerable progress in improving their asset qualities whereas specifically Novo Banco stands out with alerting high NPL ratios. Further, BPI and Santander Totta show sound capitalization measures, even after the latter´s integration of BPP. Novo Banco`s week capital stance is strongly dependent on the prospected 1 € billion capital injection of its buyer Lone Star. The considerably low profitability of most banks further detains internal capital generation.

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Financial Sector - Novo Banco Sale

Novo Banco successfully settled with bondholders to repurchase bond securities in order to increase the bank´s capital ratio by € 500 million, a condition necessary for the bank´s sale to Lone Star. The realization of the Novo Banco sale implies a significant destressing for the financial sector. The sale agreement with Lone Star contains following key conditions:

Lone Star (obtains 75% share)

- Capital injection of € 1 billion (€750 million at point of purchase, €250 million until 2020).
- No dividend distribution until 2025, no position selling until 2020
- Implementation of business plan created in corporation with EU (mostly reduction of bank counters and employees)

Resolution Fund (retains 25% share)

- Contingent capital mechanism until 2025: up to € 3.89 billion guarantee if sale of problematic assets causes Novo Banco´s capital ratio to fall below a certain threshold (currently set at 12.5%).

Outlook – October:

Event Outlook - Oktober	
Date	**Event**
11-oct	OT Auction, 10 year maturities
12-oct	CPI (mm yy)
13-oct	Submission State Budget 2018
18-oct	Current Account Balance (m)
18-oct	Reopening 3m & 11 m T-Bills
20-oct	DBRS Rating Revision on Portugal
26-oct	ECB Governing Council Meeting
30-oct	Unemployment rate (m)
30-oct	Business & Consumer Confidence (m)

ECB likely to announce QE reduction as from 2018 – Oct 26

We expect the ECB to reduce its monthly asset purchase volume from currently € 60 million to € 40 million in the first half of 2018, to be fully phased out by the end of the year. The expiring public sector purchasing program (making 85% of current asset purchases) will be scaled back significantly, let alone due to reaching its operational constraints (in specific its self-imposed issuer limit). The corporate bond purchases will gain of relative importance. Uncertainty about deflationary effects of the euro appreciation, political instability in Spain and Italian elections in Spring 2018 will likely cause the ECB to wind down its QE program following a “drive by sight” strategy rather than a detailed outlined roadmap.

Submission of State Budget 2018 – Oct 13

The government´s proposed tax reliefs imply a decrease in IRS income twice as large as originally planned in the Stability Growth Pact (budgeted € 200 million). As much as the unanticipated strong growth performance theoretically allows for more spending (every 1 percentage point increase in GDP growth above budgeted is estimated to reduce the deficit ratio by more than 0.35 pp), it remains unclear through which channels the government intends to counterbalance spending (ruled out last year´s compensation concept through increased indirect taxation).

Following measurements have been publicly discussed:

- Increase of minimum income level from € 8500 to € 8850 per annum as from 2018 [Estimated cost: € 80 million]
- Gradual unfreezing of careers in public sector within next four years [Estimated cost: € 250 million]
- Creation of two new tax levels, among unfolding second IRS level (€ 7000 - € 20 000) into new tax line (€ 7000 - € 12000) with tax rate of 24.5% (4% below original applied rate of 28.5%) [Estimated cost: € 200 million]
- Pensions up till € 823,6 will be adjusted for inflation, for the first time since 2009 [Estimated cost € 140 million]
- Suspension of 10% reduction of unemployment benefits after 6 months
- PCP wants companies with profits above € 35 million to pay higher profit surtax (“Derrama estadual”) (9% instead of 7%) [Estimated potential additional income source: € 100 million]

IGCP – this month:

- Oct 11th: Auction of OT lines *Oct 2022* and *Abr 2027*, indicative amount set between €1 - €1.25 billion
- Oct 16th: Auction of 3 & 6 months BTs, indicative amount set between € 1 - 1.25 billion
- Oct 18th: Amortization of OT line *Oct 2007* worth more than € 6 billion (corresponds to 3 % of GDP)

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MACROECONOMIC DEVELOPMENT						BiG Assessment	Forecasts		
						Development 2017	EC	Stability Program	
	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	↑	1,8	1,8	1,9
Private Consumption	2,3	2,1	2,1	2,7	2,6	→	1,9	1,6	1,6
Public Consumption	-0,5	1,3	0,6	-0,3	-0,6	↓	0,4	-1,0	-0,8
Investment (GFCF)	5,1	6,4	0,9	7,9	9,3	↑	5,4	4,8	5,1
Imports	7,8	8,5	4,1	9,1	7,0	↑	4,4	4,5	4,5
Exports	4,3	6,1	4,1	9,7	8,1	↑	5,2	4,1	4,1
Fiscal Account (%GDP)									
Primary balance	-2,3	0,2	2,2	1,8*	-	↑	2,1	2,7	3,1
Budget balance	-7,2	-4,4	-2,0	-2,0*	-	→	-1,8	-1,5	-1,0
Public debt	130,6	128,8	130,2	128,3	-	→	128,5	127,9	124,2
External Accounts (%GDP)									
Current Account	0,1	0,1	0,7	0,70**	0,15**	→	0,5	0,2	0,5
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	↑	9,9	9,9	9,3
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)	205,7	178,1	356,5	371,1	362,1	↑			
EUR/USD	1,3	1,14	1,12	1,14	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

Cross-Country Bund Spreads					
Bps	France	Spain	Italy	Portugal	Greece
2y	21,3	46	57,2	68,1	376,9
5y	21,7	64,8	112	125,8	489,1
10y	42,6	125,3	174,2	194,7	515,1
30y	58,9	169,1	207,6	246,4	692,9
Δ 1M					
2y	-3,5	2,7	-8,4	-1,4	-4,7
5y	14,5	-2	-6,7	-27,9	4,6
10y	-2,1	5,2	2,4	-52,8	4,2
30y	-3,7	-5,7	-3,8	-31,2	-8,4

Source: Reuters, retrieved on Sept 29th 2017

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