Portugal:
Macroeconomic and financial outlook

BPI *Research*

July 2022

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BPI Grupo CaixaBank

Main messages

Activity

- **Activity benefits from the economic re-opening, accumulated savings during the pandemic and strong tourism recovery, but the outlook for the medium-term is clouded due to the global constraints.**
- **Indicators of economic activity are showing a positive performance in Q2 2022**. We do not exclude a possible "statistical correction" on growth after the strong Q1 (2,6% qoq), but our central prediction points to an advance of 0.3% qoq in Q2 2022.
- **High frequency indicators related to the tourist sector point to a strong summer season**. The number of flights in June exceeded in 9% the level of June 2019 and according to World Travel & Tourism Council the number of flights booked for the Summer months puts Portugal in the 4th most popular destination in Europe.
- **Headline inflation increased to 8,6% in June and core inflation, excluding all energy and unprocessed food, increased to 6,0%**. Supply bottlenecks and commodity prices continue to put pressure on inflation and are forecast to do so for longer than previously anticipated. **We revised the forecast for headline inflation to 7,1% in 2022 and to 3,2% in 2023**.
- **We expect GDP to grow 6,6% in 2022 and 2,0% in 2023, in line with European Commission Summer forecasts of 6,5% and 1,9%.** The Russia-Ukraine war, and its consequences, are now expected to last longer. Our central scenario does not assume a complete cut of Russian exports of gas to Europe.
- **We expect the ECB to increase rates until March 2023 towards neutral levels of 1.25% (depo rate), somewhat below market expectations**. Net asset purchases under APP ended on July 1st and, in its June meeting, the ECB pre-announced that it would hike rates by 25bp in July and, most probably, by 50bp in September. We expect additional 25 bps hikes in October, December, January and March. The ECB is also expected to announce in July a new anti-fragmentation tool that we expect will help contain the risk premia of peripheral countries although we do not rule out some short-term volatility.
- **Housing prices carry strong momentum due to the upbeat tone of demand and the surge in construction costs, but the increase in interest rates will weigh on the market in 2023**. Prices should increase 10.1% in 2022 according to our scenario, but a considerable slowdown is expected in 2023, to 1,5%. The likelihood of a severe correction in prices is quite low as prices remain in line with fundamentals and supply progresses smoothly.
- **After the end of central bank net asset purchases in July**, the ECB will have covered 22% of the Government's financing needs for 2022. For 2022, the fiscal deficit is expected to decline to 1.7% of GDP (2,8% in 2022). And the public debt ratio to 119,5% of GDP from 127,4% in 2021. Still, according to IMF in a scenario of unchanged policies, public debt is seen to fell below 100% in the medium term. At last, the Treasury liquidity cushion amounts to circa €26 bln (≈12% of GDP), close to historical maximums (2018:€27 bln).
- **The Government adopted a set of measures to limit the impact of higher energy prices due to the war in Ukraine, ~1.6 bln euros (0.7% of GDP).**

Banking sector

- **Credit quality indicators improved further in Q1 2022 and risks related with higher housing prices are contained,** as macroprudential measures are relatively tight. Recently, additional measures were taken in order to reduce the maturity of housing loans and to test the impact on the debt service of an increase of 300 basis of interest rates on mortgages loans.

Main economic forecasts

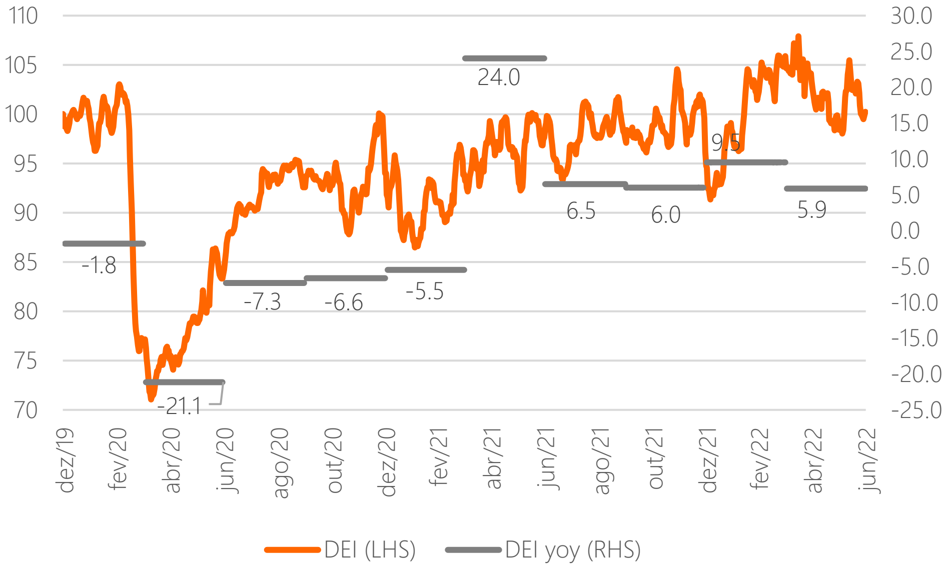
%, yoy	2014	2015	2016	2017	2018	2019	2020	2021	Forecasts 2022	Forecasts 2023
GDP	0,8	1,8	2,0	3,5	2,8	2,7	-8,4	4,9	6,6	2,0
Private Consumption	2,4	2,0	2,6	2,1	2,6	3,3	-7,1	4,5	5,9	2,1
Public Consumption	-0,6	0,8	0,8	0,2	0,6	2,1	0,4	4,1	1,7	0,0
Gross Fixed Capital Formation (GFCF)	2,3	5,9	2,5	11,5	6,2	5,4	-2,7	6,4	5,1	7,3
Exports	4,3	6,3	4,4	8,4	4,1	4,1	-18,6	13,1	12,8	5,1
Imports	7,9	8,0	5,0	8,1	5,0	4,9	-12,1	12,9	8,6	6,7
Unemployment rate	14,5	13,0	11,4	9,2	7,2	6,6	7,0	6,6	5,9	5,7
CPI (average)	-0,3	0,5	0,6	1,4	1,0	0,3	0,0	1,3	7,1	3,2
External current account balance (% GDP)	0,2	0,2	1,2	1,3	0,6	0,4	-1,2	-1,1	-2,2	-1,1
General Government Balance (% GDP)	-7,4	-4,4	-1,9	-3,0	-0,3	0,1	-5,8	-2,8	-1,7	-0,7
General government debt (% GDP)	132,9	131,2	131,5	126,1	121,5	116,6	135,2	127,4	119,5	116,6
Risk premium (PT-Bund) (average)	252	189	307	269	138	98	89	60	100	107

***Source**: BPI Research.*

GDP: strong growth in Q1 22 and positive data so far supports growth in 2022

Daily economic indicator

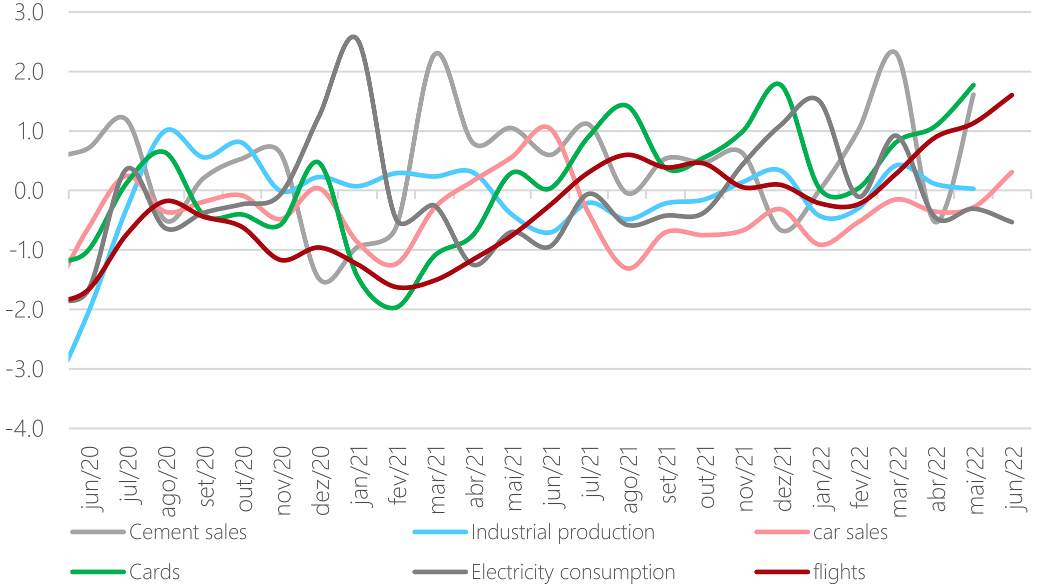
Dec 2019 = 100



***Source**: BPI Research, from BoP*

Economic indicators

normalized indices[1]



Note:** normalized series have a mean of zero and standard deviation of **1
***Source**: BPI Research, from INE.*

- **In 1Q22, GDP grew by 2.6% qoq and 11.9% yoy and exceeded in 1.2% the 4Q 2019 level.** Private consumption and tourism recovery were the drivers of growth, but investment also performed well. Domestic demand contributed with 10.1 percentage points to the year-on-year growth and foreign demand with 1.7 p.p..
- **In the meantime, most high frequency data suggests that activity continues to expand in Q2, albeit at a slower pace.** The daily economic indicator points to a deceleration but continues comfortably on positive field; payments with electronic cards and car sales indicates solid consumption; and the number of flights shows tourism recovery proceeding. On the other hand, industrial production points to slowdown, reflecting cost increases and persistent supply bottlenecks.
- **Uncertainty is high and risks are biased on the negative side especially due to high inflation and harsher financial environment. Hence, after the strong pace of growth in 2022 (we expect 6,6% , supported by a carry-over effect of 3.4 p.p.), we anticipate a slowdown to 2% in 2023.**

But the pace of expansion will slow up to the end of the year

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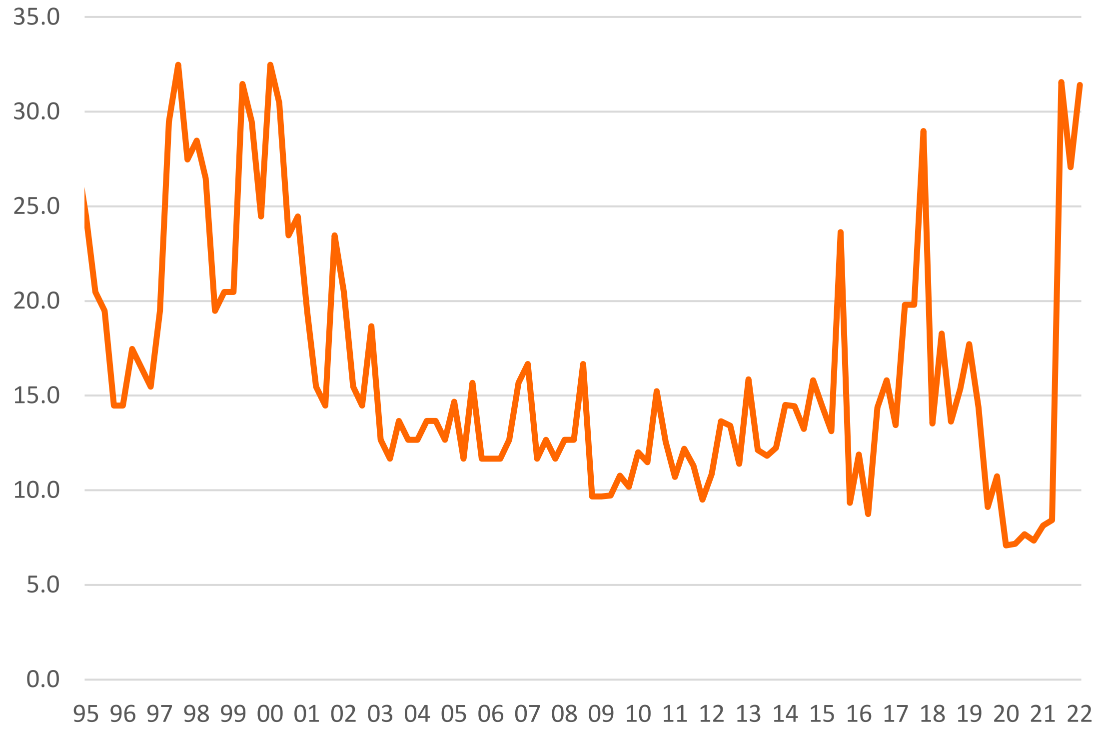
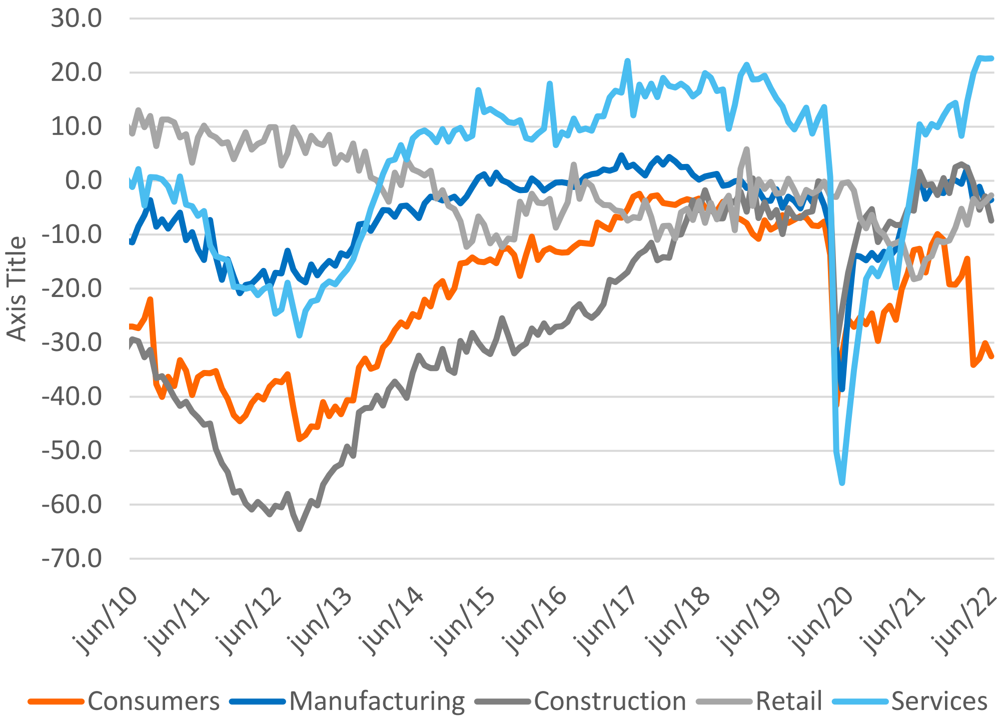
Confidence surveys: obstacles to the activity in industry - shortage of raw materials

Level



Confidence indicators

Level

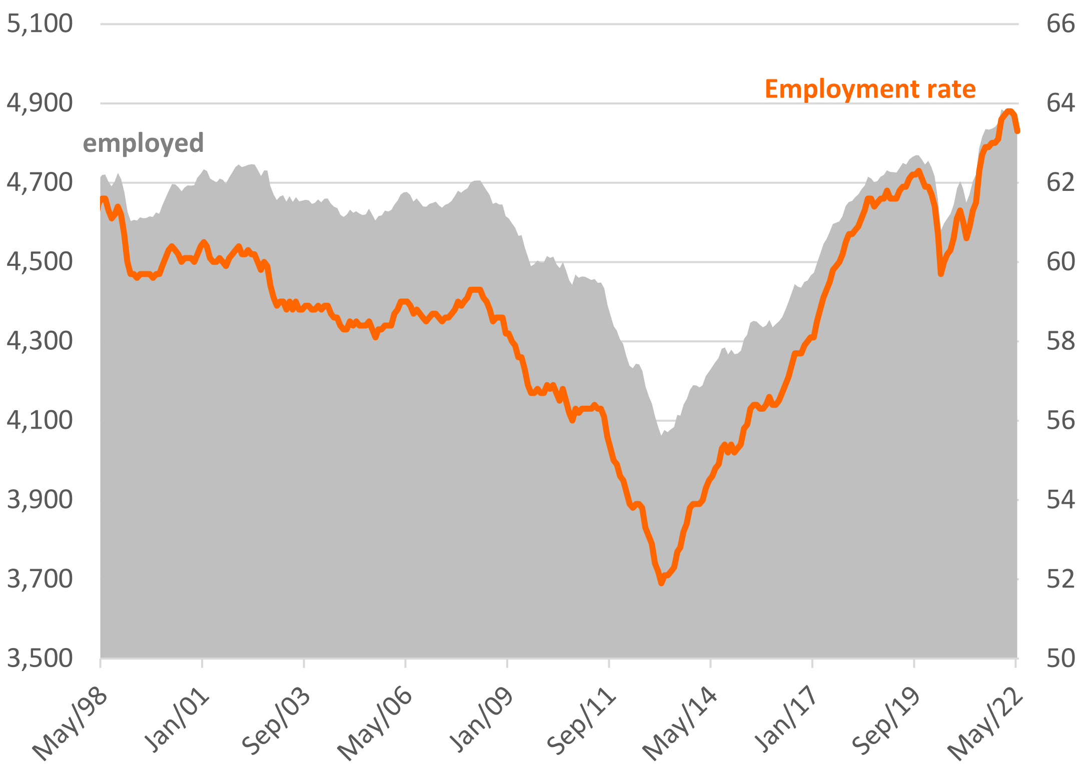


***Source**: BPI Research, from INE.*

- **Shortage of raw materials continues to be referred as an important obstacle to activity,** raising risks to the supply side of the economy**.** Manufacturers continue to report the lack of inputs as one of the main constrains to production.
- **Sentiment indicators:** Consumers kept at low levels; construction falls due to cost increase; services and industry improve, but business prospects in the coming months have been worsening, suggesting a possible reversal of the trend in the coming months.

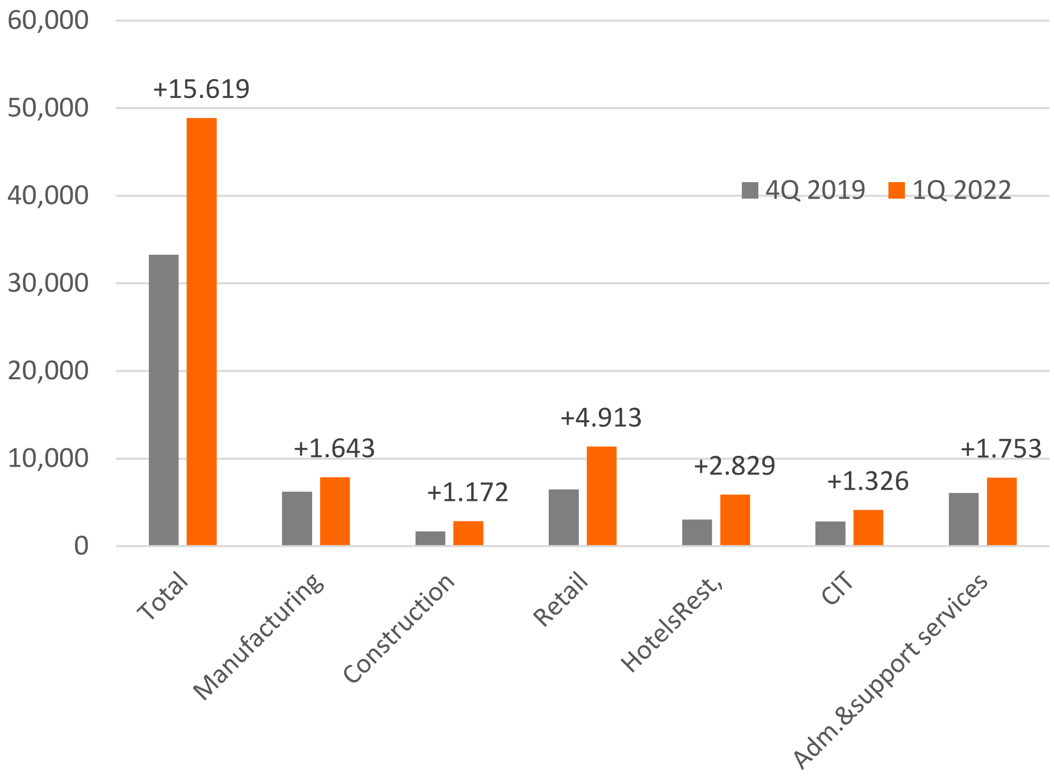
Robust labor market with signs of scarcity

People employed and employment rate
Mil persons



Source: *BPI Research, from INE.*

Unfilled job vacancies
Number of vacancies

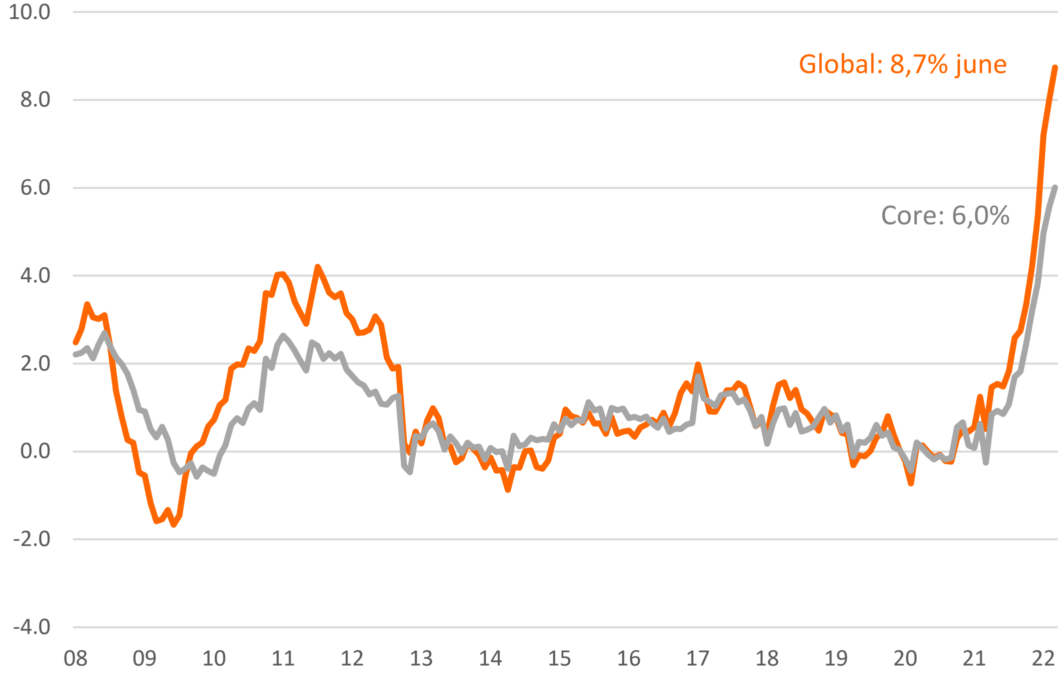


- **Employment is at maximum levels** and labor market data suggest that will continue there. This is an important factor supporting consumption and economic growth.
- **Difficulties in hiring** is one of the obstacles pointed out by companies.

Inflation: still accelerating add inflationary pressures up to the year end

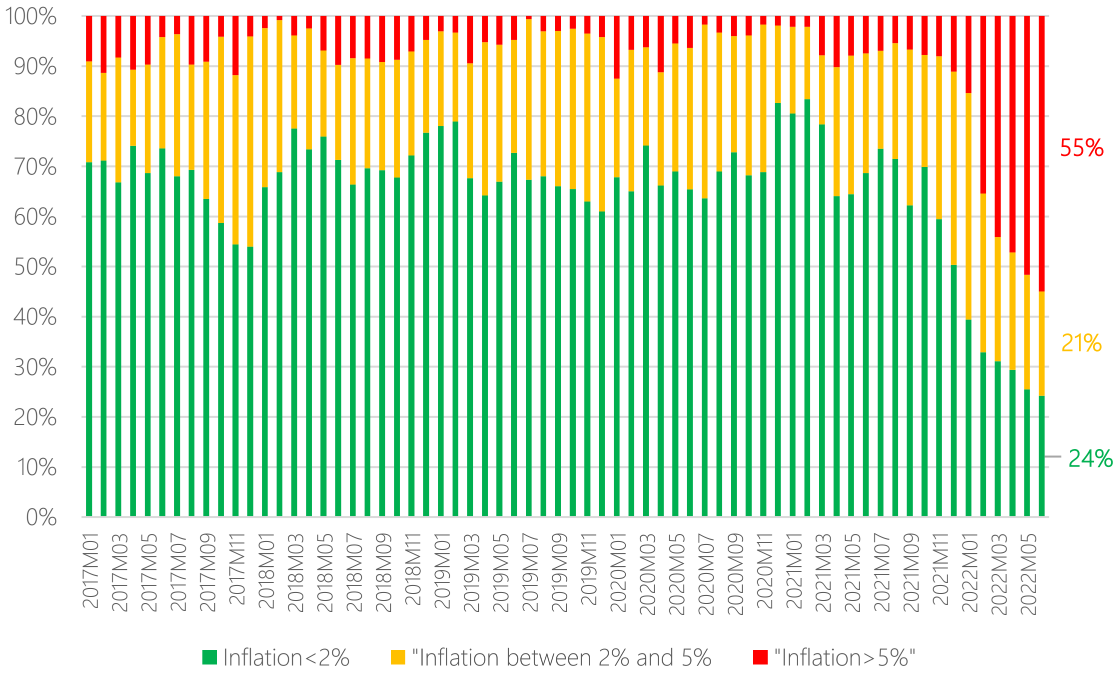
The global and core inflation

Year-on-year (%)



The inflation traffic light

% of CPI basket



***Source**: BPI Research, from INE.*

- **Inflation accelerated again in June** to 8.7% (8.0% in May), driven by higher prices on energy component and non-processed food. Additionally, high energy prices have been spreadings to other components (processed food for example), intensified by the impact of scarcity of inputs in a period of higher demand. Core inflation accelerated to 6.0%, from 5.5% in May.
- **Forecast for Inflation in 2022 revised upwards to 7.1% from 6.5%** reflecting higher prices on energy and contagious to other classes. **Risks continue tilted to the upside**.

The government unveils a fiscal package to cushion the impact of the war

The fiscal package will have a direct cost of €1.6bn euros (0.7% of GDP), includes €0.5bn in credit lines

To cushion the impact on households

- **Most vulnerable families:** support of €60 in order to mitigate increase of prices of basic necessities + support of 10€/month to acquisition of bottled gas. Estimated tax cost: €55 mln.
- AutoVoucher - Reimbursement of 40 cents/lt of fuel, up to €20/month (march and April). Estimated tax cost: €133 mln.
- Reduction of tax on oil products equivalent to a cut of VAT to 13% and fiscal neutrality. Estimated tax cost: €287 mln/month.
- Temporary suspension of the carbon tax. Cost: €360 mln.
- Reduction in tariffs for access to electricity networks

Sector related measures

- **Agriculture and livestock**: reduction or exemption of oil tax on agriculture oil; support to mitigate increased costs with animal feed and fertilizers. Total €65 mln. Lines of credit: for the swine and milk sectors: €9 mln; for dry support: €50 mln.
- **Transport sector**: support to mitigate impact of higher fuel prices (30 cents/lt). Cost: € 75mln. Support to public transports.
- **Gas intensive industries**: grants to support companies' rising gas costs; non-refundable support covering 30% of the difference between costs incurred in 2021 and those incurred in 2022 (max €400 mil/company): € 160 mln
- Flexibility of tax payments and SS contributions to the most vulnerable sectors: agriculture, fisheries, transport, textiles, pulp manufacturing, ceramics and glass industry, steel, cement production and the chemical industry.

Sector related measures

- **'Apoio à Produção' credit line for manufacturing and transport industries**: covering 70% of the credit, within a period of up to 8 years; 12-month grace period for capital. Requirements: weight >= 20% of energy costs in production costs; Increase in the cost of goods sold and consumed >= 20%; Drop in operational invoicing >= 15% due to reduction in orders related to scarcity or difficulty in obtaining raw materials, components or intermediate goods. €400 mln.

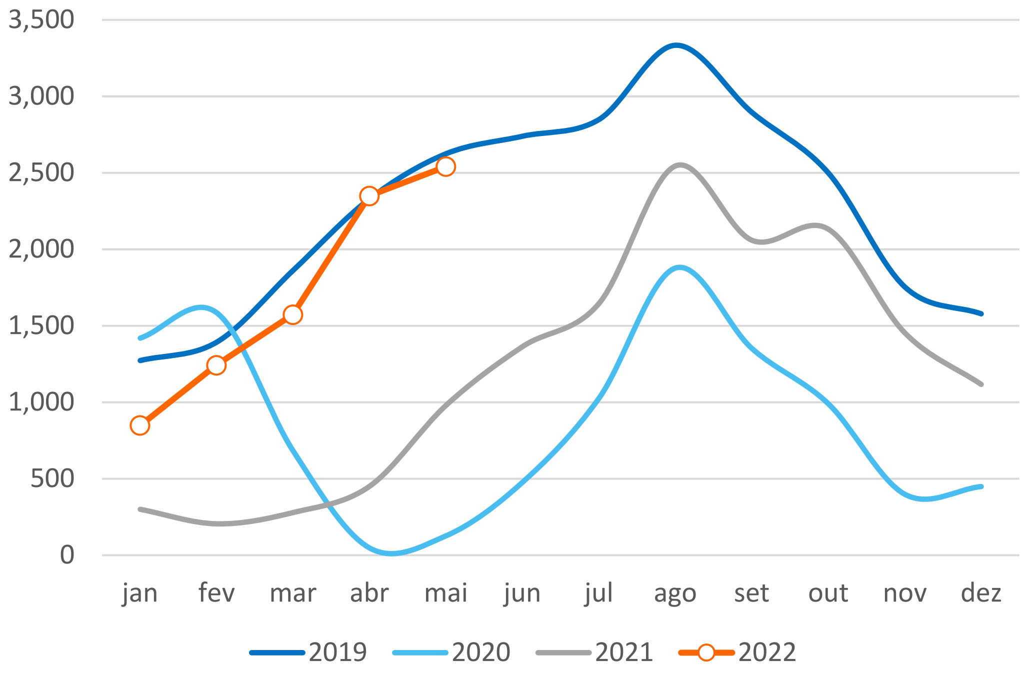
Others

- Support for refugees: €50 mln
- Support for installation of photovoltaic panels in agro-industry, farms and hydro-agricultural developments: €46 mln
- Simplification of procedures related to the decarbonization of the solar panel industry in agro-industry, agricultural exploitation and hydro-agricultural developments and reinforcement of support funds: €97 mln.
- Reduction to the minimum rate of VAT on all electrical equipment that allows families to be less dependent on gas.

Tourism is recovering as Covid related restrictions were removed

Number of guests (foreign and national)

Thousand



***Source**: BPI Research, based on INE data.*

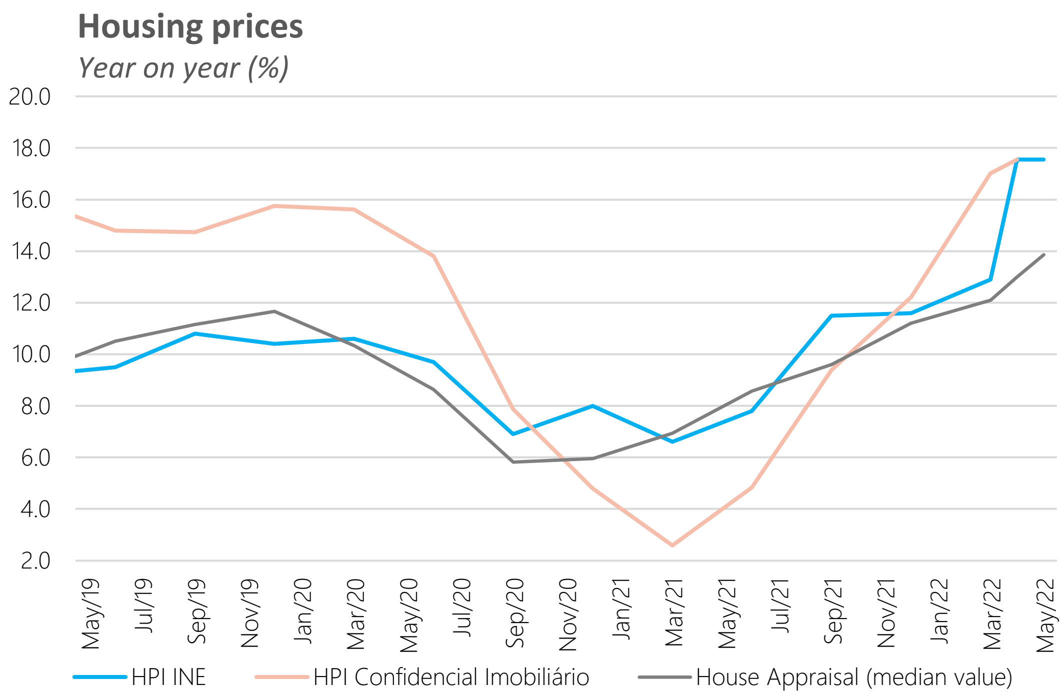
Number of guests (foreign and national)

Thousand

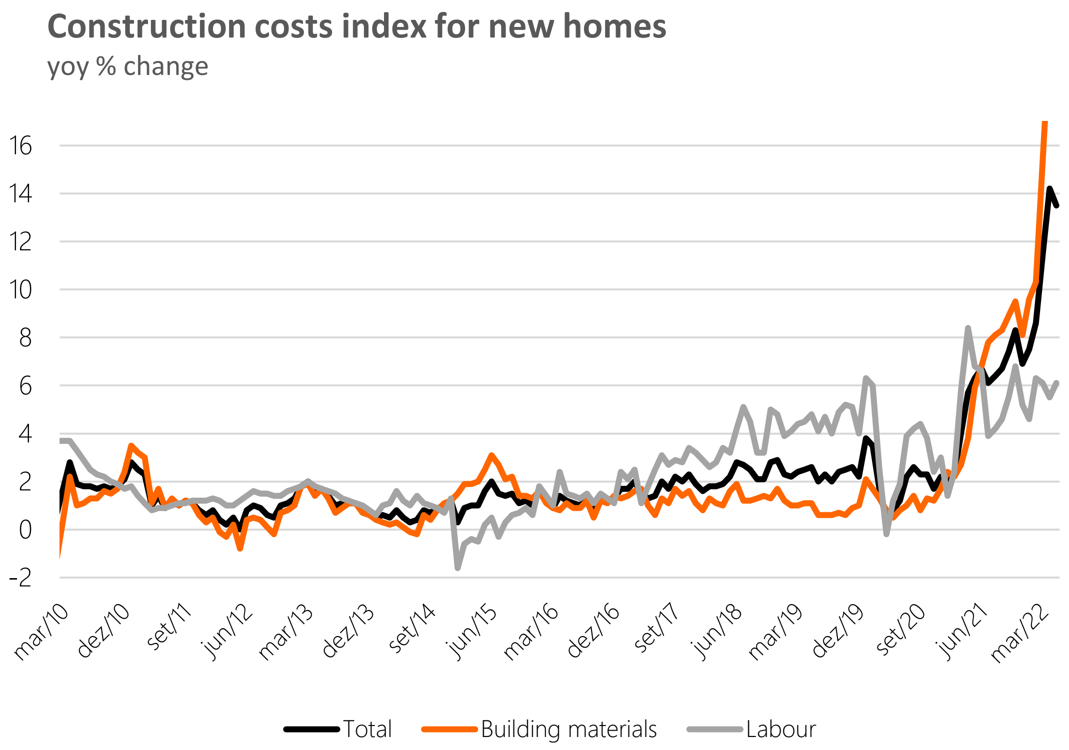
	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	may/22
TOTAL	-94%	-83%	-53%	-31%	-29%	-8%
UK	-97%	-80%	-61%	-35%	-21%	1%
Germany	-93%	-84%	-57%	-1%	-6%	-4%
Spain	-92%	-70%	-37%	-27%	-44%	-7%
France	-91%	-83%	-32%	-9%	-15%	-10%
Europe (others)	-93%	-81%	-44%	-16%	-22%	-4%
Brazil	-95%	-93%	-85%	-55%	-47%	22%
US	-97%	-94%	-63%	-37%	-9%	-32%
China	-99%	-98%	-94%	-91%	-85%	-78%
Others	-93%	-87%	-66%	-49%	-38%	-16%

- **Guests: for the first time in April it was surpassed the same pre-pandemic month (+1%); in May, the performance was close (only -3%).** In both months, resident tourists surpassed the numbers of 2019. The pace of recovery of non-residents, especially non-European tourists, is slower.
- Income from tourist accommodation establishments accumulated until April is still -4% compared to the same period in 2019.
- In the most recent booking surveys Portugal is identified as one of the most resilient destinations in 3Q 2022 (only -9% of international tourists in 2019).
- **Despite this good behavior, we only expect the sector to recover to above pre-pandemic levels in 2023.**

The real estate sector: resilience and solid fundamentals



Source: *BPI Research, based on INE and Confidencial Imobiliário data.*

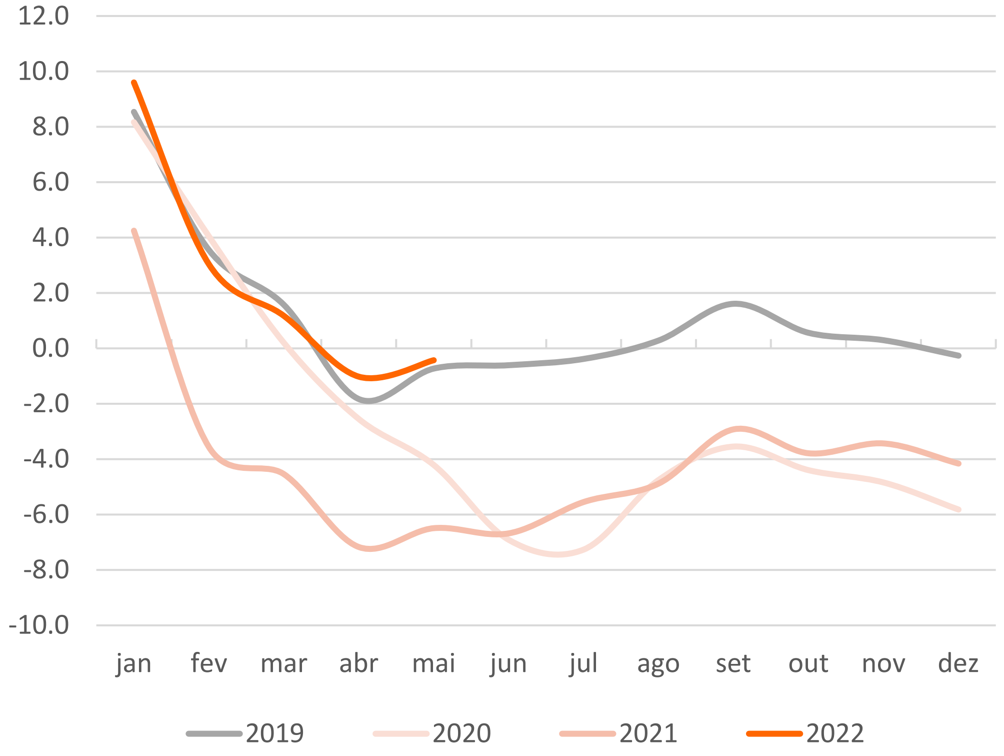


Source: *BPI Research, based on INE data.*

- Housing prices continue to accelerate and going forward **the market should continue resilient as there are no signals of oversupply. On the other hand, prices are expected to moderate in the future**, in line with the end of Vistos Gold in main cities as well as some cooling down expected from domestic buyers due to the end of some Covid-related supporting measures (namely moratoriums), the upward trend in interest rates, and also due to the impact of inflation on disposable incomes. **Housing prices increased 9.4% in 2021, are expected to accelerate slightly to 10% in 2022, but afterwards we expect a cooling down reflecting the harsher financial environment, despite the supporting supply evolution**.

Public accounts: focused on consolidation

Public Balance (cash basis) plan 2022
Year-to-date (% GDP)



***Source**: BPI Research, based on Bank of Portugal; forecasts by BPI Research*

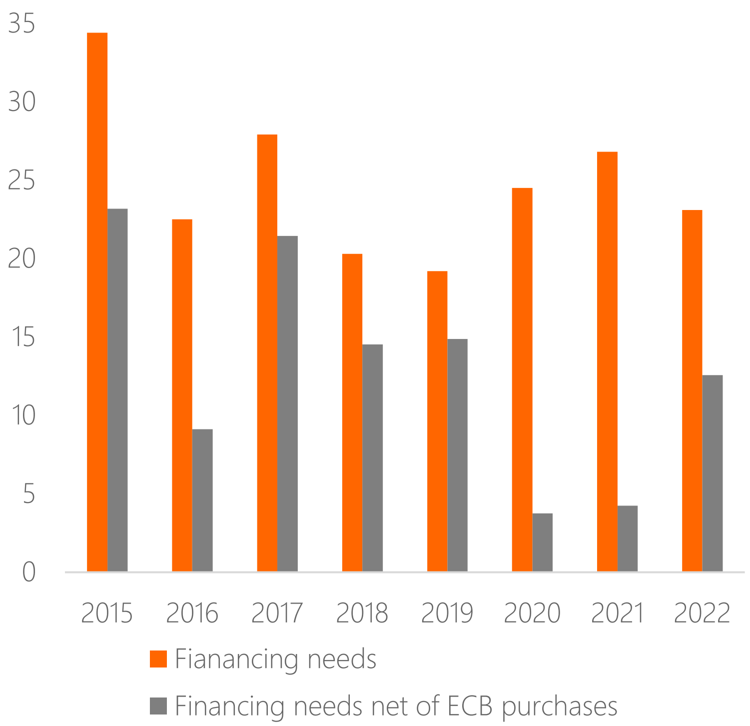
Budget execution (cash basis)
Year-to-date (% GDP, unless otherwise specified)

January-May	2019	2020	2021	2022	Var. 2022 vs 2019	Var.2022 vs 2021 (million euros)
Revenues	**36.0**	**38.0**	**35.4**	**38.0**	**2.1**	**5,107**
Tax Revenue	19.2	20.5	18.2	20.4	1.2	3,382
Social Security Contributions	9.6	10.4	10.3	10.4	0.8	918
Expenses	**36.7**	**42.2**	**41.9**	**38.5**	**1.8**	**-201**
Personnel expenses	8.6	9.7	9.7	9.2	0.5	190
Current Transfers	15.8	18.5	18.9	16.8	1.1	-620
Acquisition of Goods and Services	5.1	6.1	5.4	5.6	0.4	571
Interests	4.1	4.1	3.8	3.0	-1.0	-450
Investment	1.8	2.1	2.3	2.2	0.5	80
Budget Balance (cash basis)	**-0.7**	**-4.2**	**-6.5**	**-0.4**	**0.3**	**5,308**

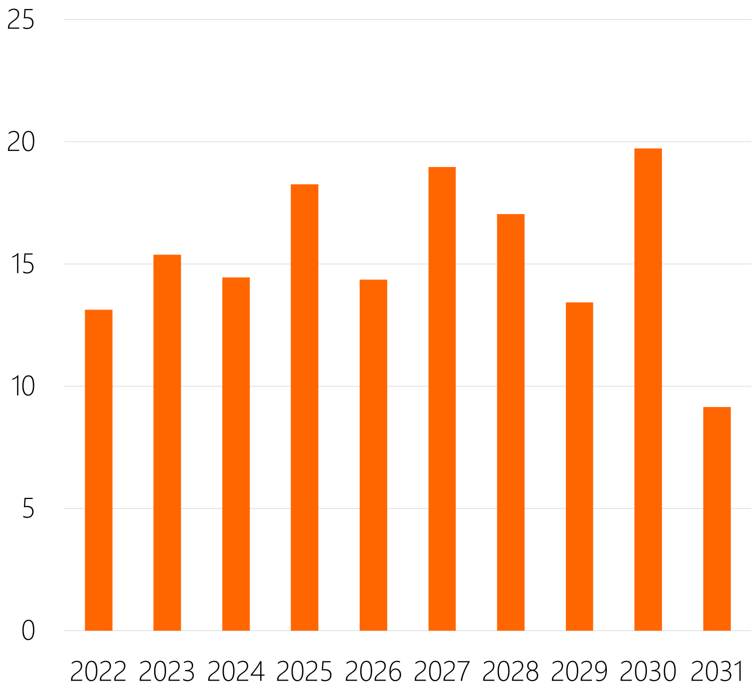
- Up to May, the public deficit (cash basis) stood below pre-pandemic levels, reflecting strong revenue growth and cost control.
- Strong labor market is contributing to the rise of revenues; and ultra-accommodative monetary policy as well as active debt management reduced the interest bill.
- Public debt (% of GDP) decreased by 7.7 p.p. to 127.4% in 2021 and to 126.8% in Q1, and is forecasted to decline to 119.5% of GDP by year end, reflecting the expected narrowing of the fiscal balance and strong nominal GDP growth. We expect fiscal deficit to reduce to 1.7% of GDP in 2022, from 2.8% in 2021, in line with the Government forecast of 1.9% of GDP.

Prudent fiscal stance, the liquidity cushion and ECB reinvestments provide comfort in an uncertain environment

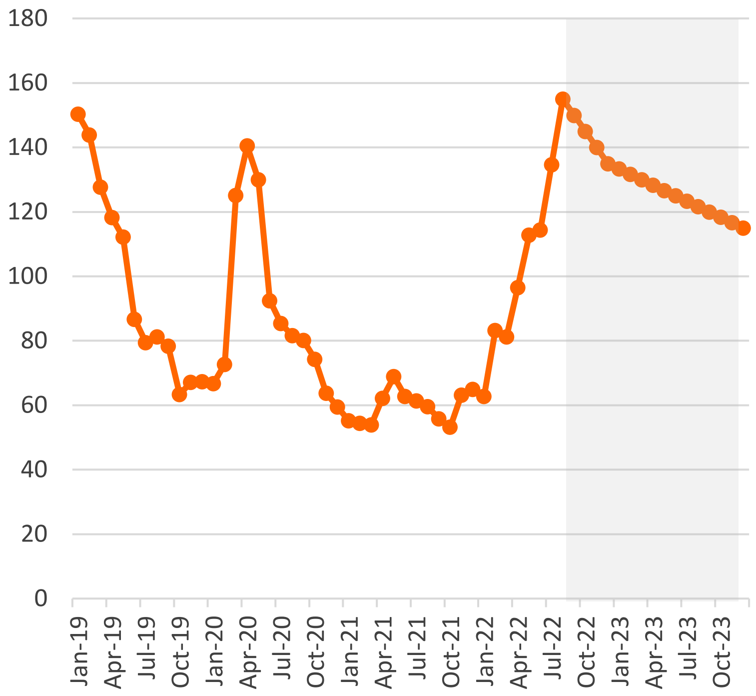
Funding needs
(Billion euros)



Portuguese Public debt Maturity Profile
(Billion euros)



Sovereign risk premium
b. p.



***Source**: BPI Research, based on Bank of Portugal; forecasts by BPI Research.*

- **Financing needs for 2022 amount to €23 bn, minus €4 bn than in 2021.** Assuming the end of the APP program in July (PEPP ended in March), ECB's net acquisition of Portuguese debt may decline to around €5 bn, circa 20% of financing needs in 2022, pushing net financing needs not covered by the ECB to pre pandemic levels. Still, the current liquidity cushion amounts to around €19 bn (c. 9% of GDP) and the Treasury is forecasting its maintenance up to the end of 2022.
- The Portuguese treasury is carrying out a policy of repurchase of short-term securities and selling bonds with longer maturities, removing pressure on public debt in the short term. The Treasury recently repurchased €763 million of debt maturing in 2023 and 2024 and sold debt maturing in 2028 and 2035.
- The sovereign risk premium has increased following the end of net asset purchases, but we expect it to remain within reasonable bounds once the ECB unveils a new anti-fragmentation tool.

The Portuguese banking system:
In a solid position to face a more stressed environment (1)

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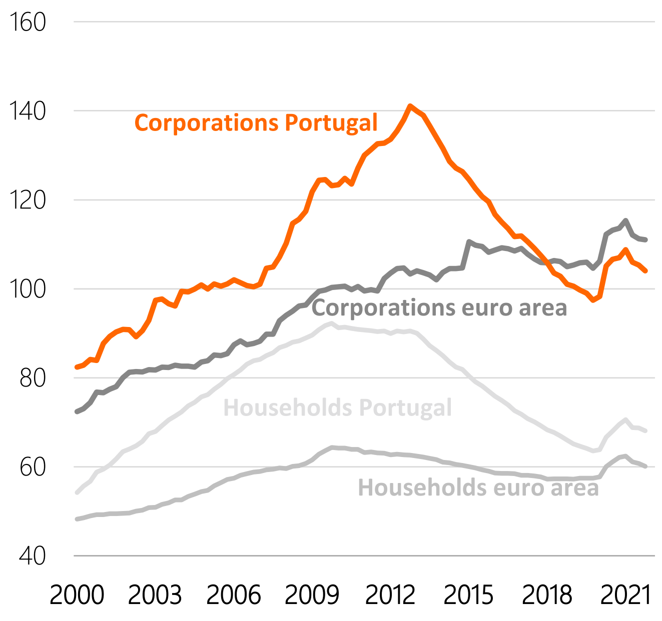
Gross private debt
% of GDP, non consolidated debt.

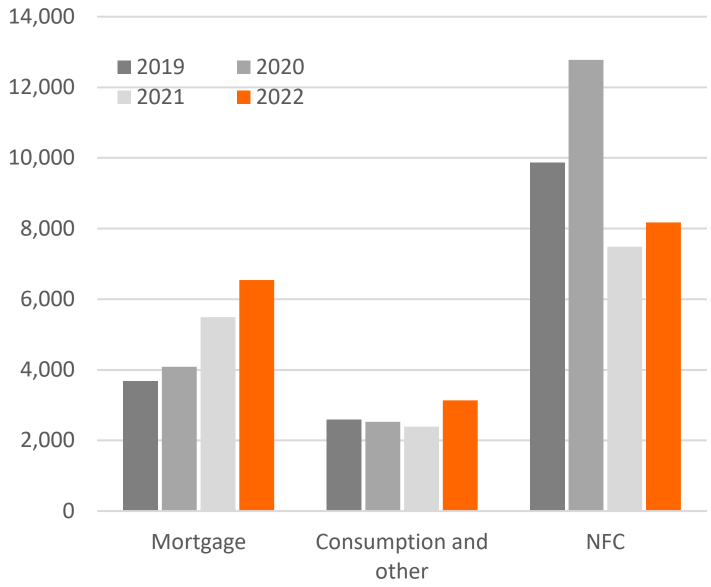


Source: *BPI Research, based on Eurostat and BoP*

Private domestic credit
Year on year (%)

	May 2021 % yoy	May-2022 % yoy	2022 (For.) % yoy
Credit to the non-financial private sector	**4,7%**	**2,6%**	**-0,9%**
Households	**2,5%**	**3,7%**	**0,7%**
Housing mortgages	**3,2%**	**3,0%**	**1,3%**
Other purposes	**0,3%**	**6,2%**	**-1,7%**
Consumer lending	**0,3%**	**6,2%**	**0,9%**
Non-financial corporations	**8,4%**	**0,8%**	**-3,6%**

New lending activity by sector
Accumulated in the year, Bn euros

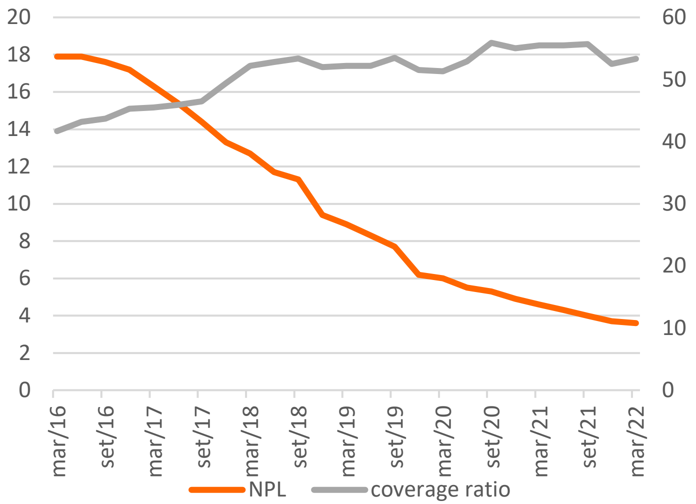


- **The end of moratorium justifies the return of the deleveraging trend in the private sector.** Corporate debt levels remain below euro area average despite the recent pick-up in credit outstanding (mostly due to state guaranteed credit lines). Household debt shows more gradual reduction, reflecting expanding mortgage lending.
- **In 2021, new lending for the non-financial private sector contracted 11.4% yoy, reflecting the fall of new credit to NFC (-33.5%).** However, when excluding Covid-related credit lines, credit to companies decreased less (-9.9% yoy). New operations for households showed a strong performance, especially on mortgage operations (increasing housing prices, financing conditions, employment-supporting measures).
- **Up to May 2022, new operations showed a positive trend: new credit for NFC and households increased 9.2% and 22.8%, respectively. The dynamics was especially positive since March, specially for NFC; mortgage credit continues very strong even if it is decelerating. However, the interest rate on new mortgage credit have started to increase, reflecting the market expectations for the monetary policy normalization. This increase, as well as the setback in confidence after the Ukraine war, could cool down the new mortgage credit operations.**

The Portuguese banking system:
In a solid position to face a more stressed environment (2)

NPLs and coverage ratios

%



Cost of risk[1]
0.5% in 2019
0,3% in Q1 2022

Note (1): flow of impairments to credit as a percentage of total gross.
Source: Bank of Portugal

Banks' profitability

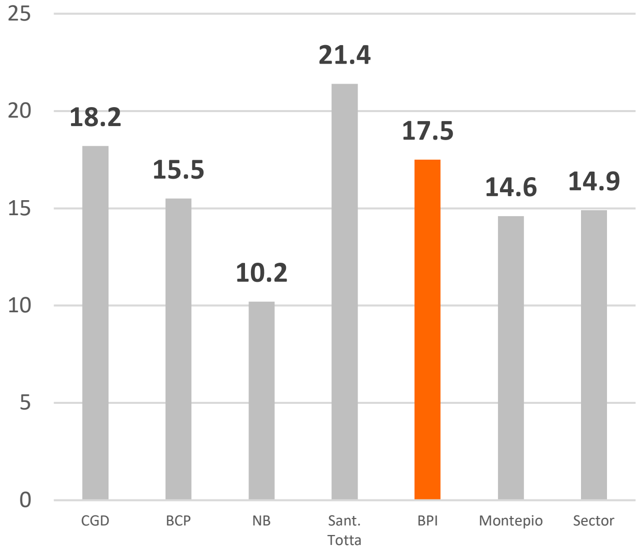
In % of average total assets (Q1 22; trailing 12M)

	BPI	BCP	San Totta	CGD	NB	Montepio
Net interest income	**1,1%**	**1,3%**	**1,3%**	**0,7%**	**1,2%**	**1,2%**
Net fees	0,7%	0,8%	0,8%	0,5%	0,6%	0,6%
Gains on financial asset	0,1%	0,3%	0,1%	0,1%	0,8%	0,3%
Other net profits	-0,2%	0,1%	0,0%	-0,2%	-0,2%	-0,1%
Gross income	**1,7%**	**2,6%**	**2,2%**	**1,3%**	**2,4%**	**1,9%**
Operating expenses	-1,1%	-0,9%	-0,8%	-0,9%	-0,9%	-1,2%
Impairments losses, taxes,	-0,2%	-0,8%	0,1%	0,4%	-0,2%	0,0%
Profit	0,3%	0,7%	1,0%	0,5%	1,3%	0,2%
ROTE [1]	8,3%	8,2%	13,6%	7,2%	nd	nd

Notes: 1) the values for BCP and CGD refer to ROE; calculation methodologies differ between banks.

Banks' solvency and liquidity position

In % (Q1 22)



Source: Banks publications, BoP

- **NPLs continue to decline, despite the fact that debt moratoria have already expired.** The NPL ratio declined by 1 tenth to 3,6% in 1Q22.
- **Profitability is improving on a moderate basis, exceeding levels in the pre-pandemic period (ROE stood at 8,4% in 1Q22 and 5,4% in 4Q21 at the consolidated level). In addition, the predictable hike in interest rates represents a tailwind for Portuguese banks.**
- **The capital position of Portuguese banks provides buffers against the risks that could arise due to the conflict in Ukraine. The CET1 ratios remain above the regulatory minimum.**

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