Portugal:

Macroeconomic and financial outlook

BPI *Research*

September 2022

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Main messages

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Activity

- **GDP stagnated in Q2, but the positive year-on-year trend remain, growing 7,1%. Exports were the main support of growth, reflecting a strong acceleration on goods exports and maintenance of strong growth on services, mainly due to the revival of tourism.**
- **High frequency indicators related to the tourism sector point to a strong summer season**. in July the number of tourists surpassed the same pre-pandemic month (+6,3%), for the 2nd time this year, 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 decreased to 9% in August, but core inflation accelerated to 6,5%**. Supply bottlenecks and commodity prices continue to put pressure on inflation and are forecasted to do so for longer than previously anticipated. **Risks to our forecasts are biased on the upside**.
- **Indeed, our macroeconomic scenario is under revision:**
- **GDP growth in 2022 will probably exceed the 6% level, but should stay below our prediction of 6,6%. The scenario is less positive for 2023, as the economy faces unfavorable risks with higher negative impact in 2023. These risks are related with the energy crisis in Europe increasing pressures on energy prices and weighing on confidence, especially on the manufacturing sector. Demand will also be conditioned by a more sustained increase in interest rates as a way to fight inflation. Our current forecasts for growth in 2023 (2%) may be reduced substantially.**
- **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 probably weigh on the market in 2023**. Prices should increase around 10% in 2022, but a considerable slowdown is expected in 2023, to around 1,5%. The likelihood of a severe correction in prices is quite low as prices remain in line with fundamentals and supply progresses smoothly.
- **ECB will increase rates further than expected some months ago**. Net asset purchases under APP ended on July 1st and key rates increased by 50bp in July and 75 bp in September. Still in July, the ECB announced a new anti-fragmentation tool that we expect will continue to help contain the risk premia of peripheral countries.
- **After the end of central bank net asset purchases in July**, the ECB covered 25% of the Government's financing needs for 2022, going forward the support will remain through reinvestments and the anti-fragmention tool. 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 €25 bln (≈11% of GDP), close to historical maximums (2018:€27 bln).
- **In September, the Government adopted a set of measures to reduce the impact of inflation on households income, 2.4 bln euros (~1% of GDP),** which will be accommodated by the strong fiscal revenue increase in 1H22, with small impact on our forecasts for public deficit and debt.

Banking Sector

- **Credit quality indicators improved further in Q1 2022 and risks related with higher interest rates are contained,** as macroprudential measures are relatively tight. Recently, additional measures were taken in order to reduce the maturity of housing loans; additionally, before granting a loan, banks have also to communicate the impact on the debt service of an hypothetical increase of interest rates by 300 basis points 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	6.0	1.5
Public Consumption	-0.6	0.8	0.8	0.2	0.6	2.1	0.4	4.1	2.2	-0.5
Gross Fixed Capital Formation (GFCF)	2.3	5.9	2.5	11.5	6.2	5.4	-2.7	6.4	5.5	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	9.2	5.6
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: despite decelerating in Q2, prospects for 2022 growth remain positive, but clouds over 2023 are increasing

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Daily economic indicator

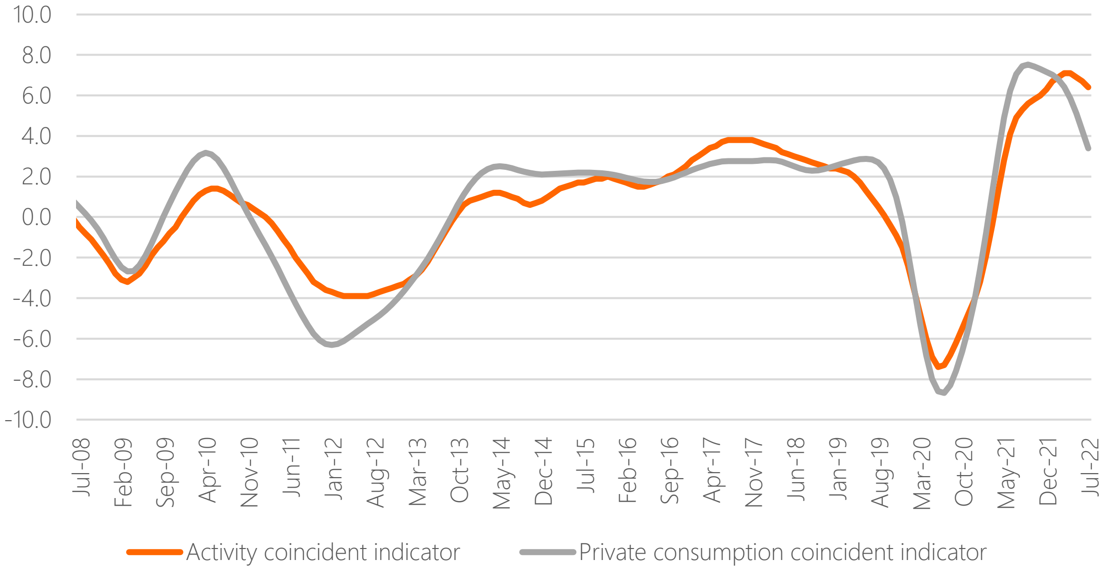
yoy

yoy month average	May-22	Jun-22	Jul-22	Aug-22
DEI	4,0	4,8	7,7	3,3

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

Coincident indicators

yoy



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

- **In Q2 2022, GDP stagnated on a quarterly basis and yoy growth slowed to 7,1%.** Exports were the main support of growth, reflecting a strong acceleration on goods exports and maintenance of strong growth on services, mainly due to the revival of tourism. Private consumption and GFCF slowed down. Domestic demand contributed with 3.7 percentage points to the year-on-year growth (10.0 p.p. in 1Q) and foreign demand with 3.5 p.p. (1.7 p.p. in 2Q).
- **In the meantime, the still scarce data for Q3 suggests that activity will perform positively in the current quarter, taking advantage of high season in tourism. For the rest of the year and in 2023, the Portuguese economy faces unfavorable risks that could dampen economic growth in 2023. These risks are related with the energy crisis in Europe that is increasing pressures on energy prices with a negative impact in consumption and production costs. Demand will also be conditioned by a more sustained increase in interest rates as a way to fight inflation.**
- **Our current forecast for 2022 will probably be slightly downward adjusted, but the 2% growth expected on our main scenario for 2023, may suffer a strong downward revision.**

The pace of expansion will slow towards the end of the year

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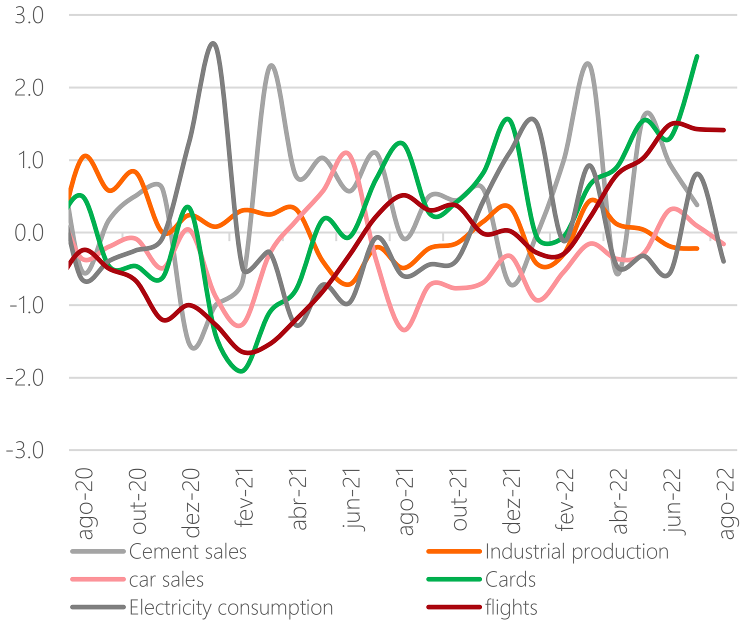
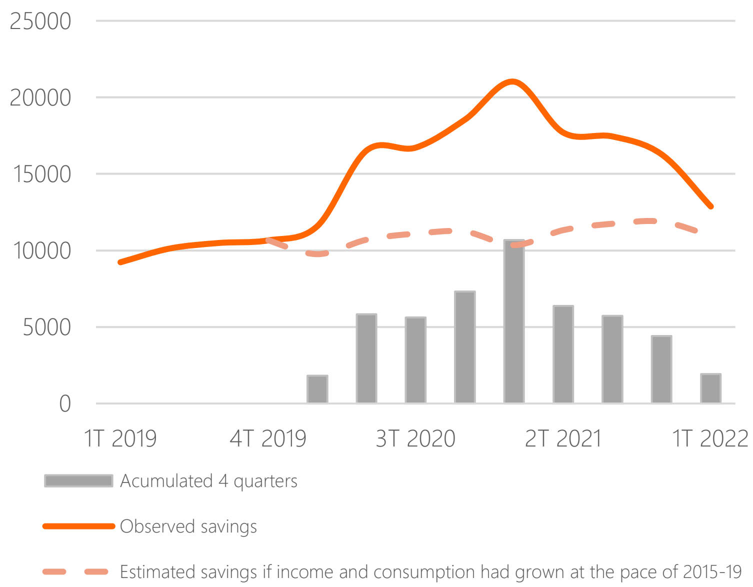
Economic indicators
normalized indices¹



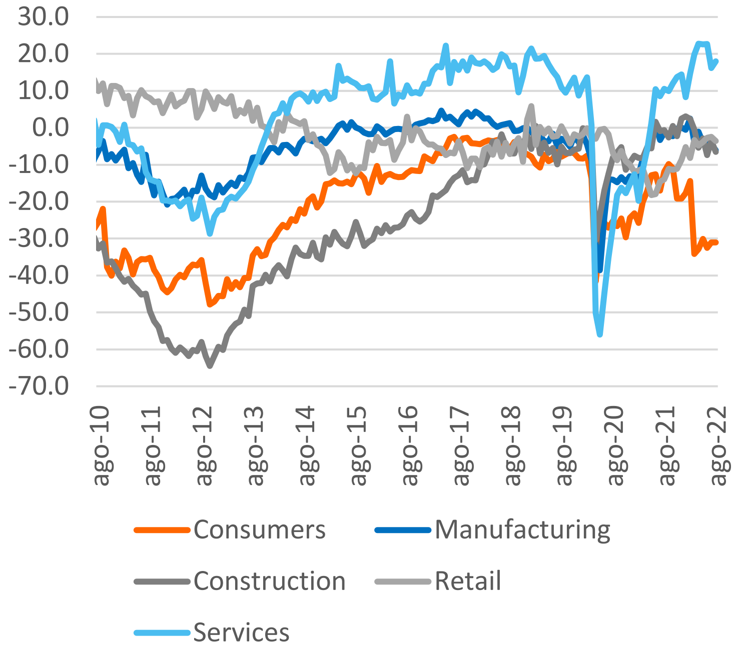
Note: normalized series have a mean of zero and standard deviation of 1
Source: BPI Research, from INE.

Savings and extra savings
Million of €



Source: BPI Research, using data from INE

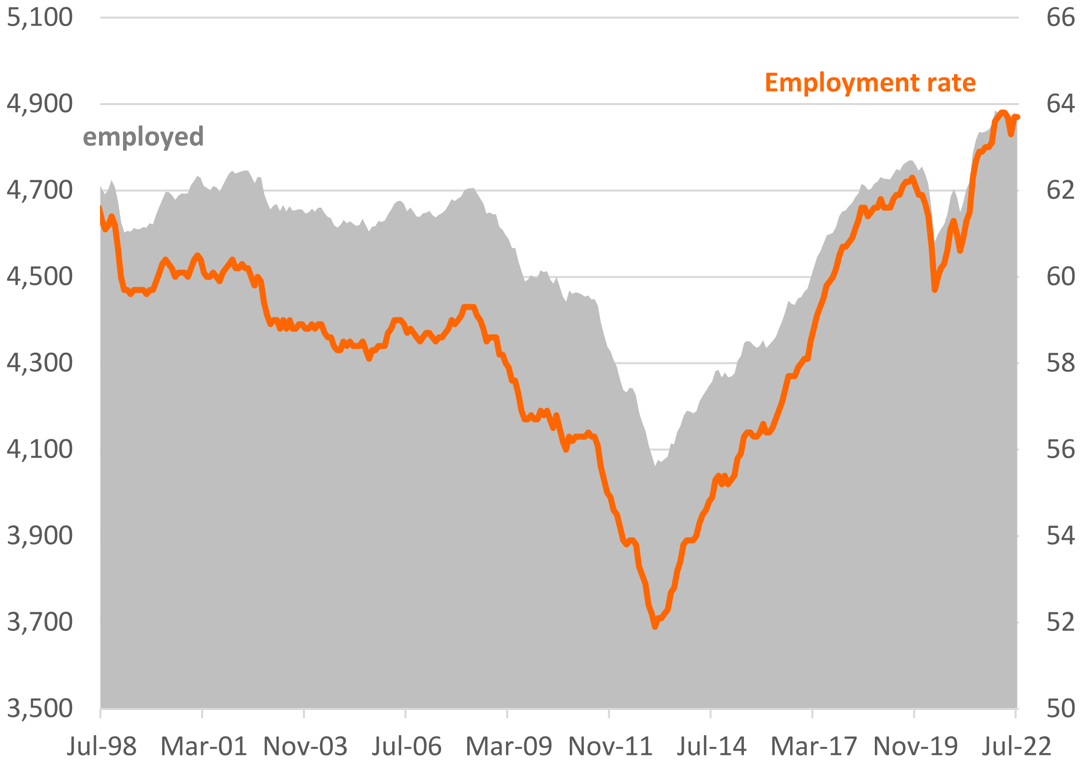
Confidence indicators
Level



- **Most high frequency data suggest a scenario of slower expansion in 2H 22.** Nevertheless, data related with consumption and tourism continues strong and showing some support to growth.
- We estimate that families had accumulated €11,6 million (5% of GDP) since the beginning of the pandemic, that will accommodate the environment of higher inflation and higher interest rates.
- **Sentiment indicators:** Consumers confidence remains unchanged, but at very low levels; in manufacturing and construction the sentiment worsened.

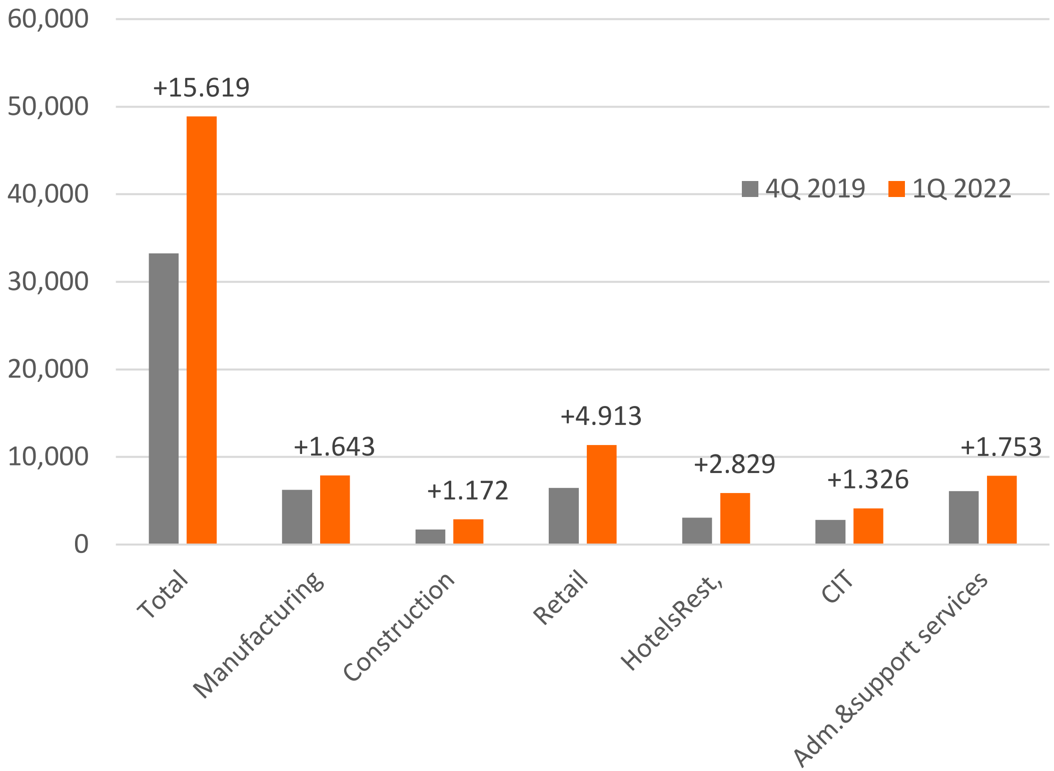
Robust labor market with signs of scarcity

People employed and employment rate
Mil persons



Source: *BPI Research, from INE.*

Unfilled job vacancies
Number of vacancies

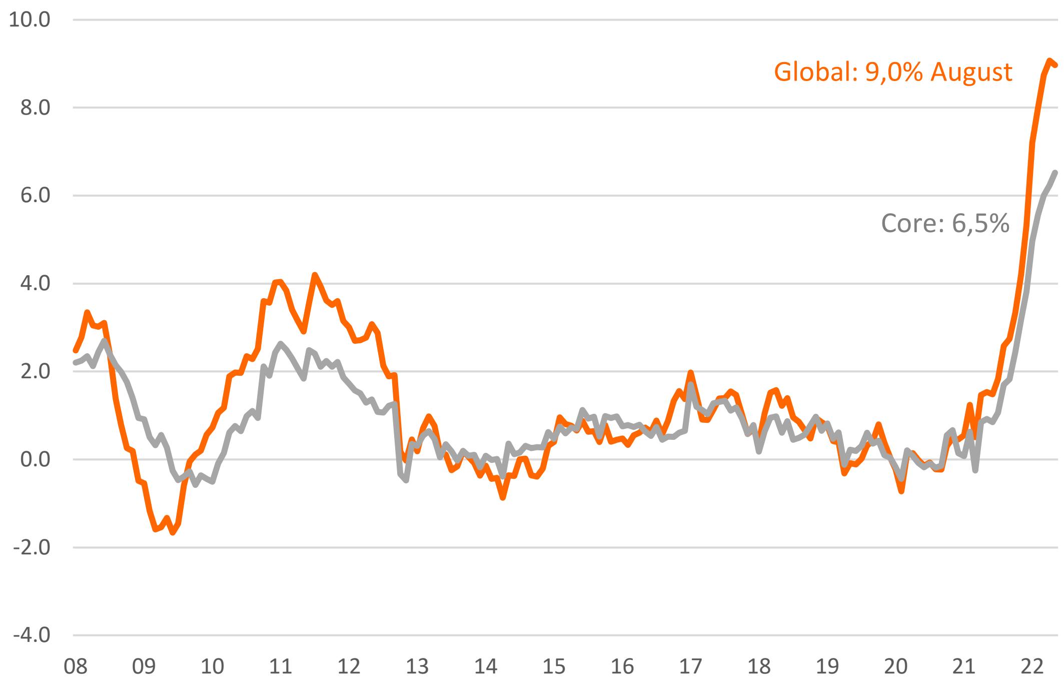


- **Employment is at maximum levels** and labour market data suggest that it will continue strong. This is an important factor supporting consumption and economic growth.
- **Difficulties in hiring** is one of the obstacles pointed out by companies.

Inflation: global inflation slowed 1 tenth in August, but the period of high inflation will be longer

The global and core inflation

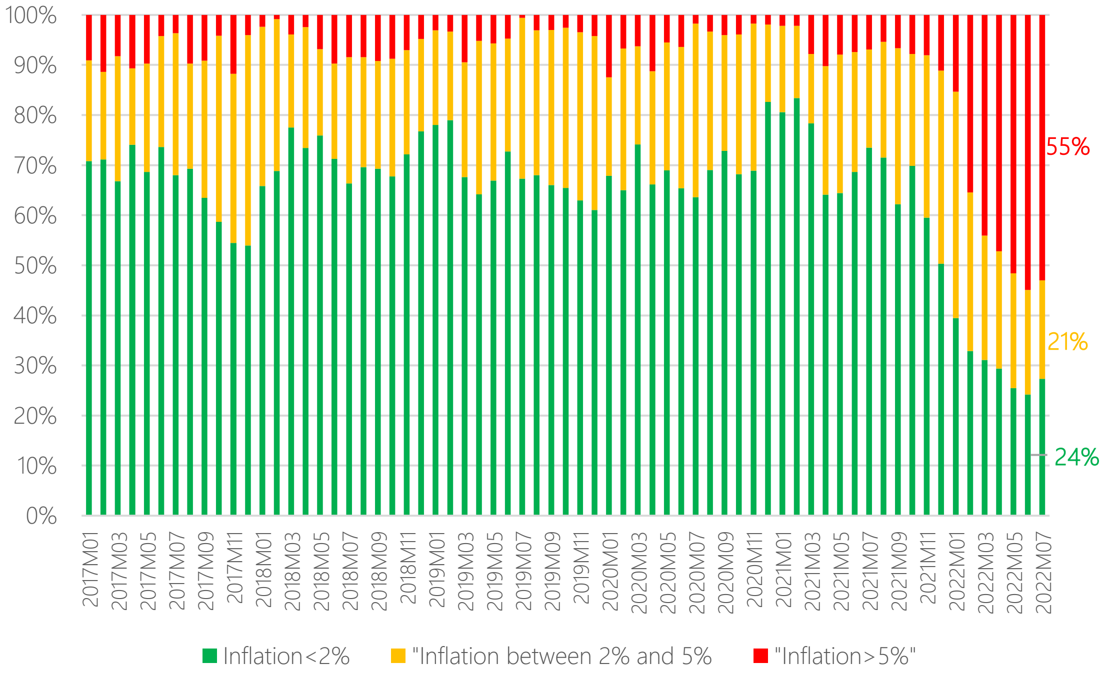
Year-on-year (%)



Source: *BPI Research, from INE.*

The inflation traffic light

% of CPI basket



- **Inflation fell** to 9.0% in August from 9.1% in July, as energy inflation slowed to 24% from 31.2%. But the environment of high energy prices has been spreading to other components (processed food for example), intensified by the impact of scarcity of inputs in a period of strong demand. Core inflation accelerated to 6.5%, from 6.2%.
- **Risks to our current forecast for Inflation in 2022 (7.2%) are biased on the upside.**

The government announced a program to reduce the impact of inflation on households' budgets

Measures included in the package amount to €2.4bn euros (~1% of GDP)

- **Individuals with a monthly income up to €2700:** one-off payment of €125 in October. 5,8 million of individuals will benefit from this measure.
- **All families regardless of income level:** one-off payment of €50 per each son up to 24 years old. 2,2 million will be covered.
- **Retired**: one-off monthly payment equivalent to 50% of the pension, with possible downward consequences on the annual revision scheduled for 2023[1].
- **Consumers:** permission to change from the liberalized gas market and return to the regulated[2] one, avoiding exponential price increases.
- **House rental:** Limit rent increases to 2%.
- **Public transports:** Freeze tariffs during 2023.
- **VAT on electricity:** reduction to 6% from 13% between October 2022 and December 2023.
- **Extension of the suspension** of the carbon tax increase; return to households of the additional VAT revenue; the reduction of the tax on oil products up to the end of 2023.

[1] The formula for calculate the update of pensions is indexed to inflation and GDP; given the strong increase of inflation and expectation that GDP will grow above 6%, this would imply an update of pensions of around 8% in 2023; the government will propose a revision of this formula in order to limit increases above 4.43%, that probably will be approved, as it have the majority in the parliament.

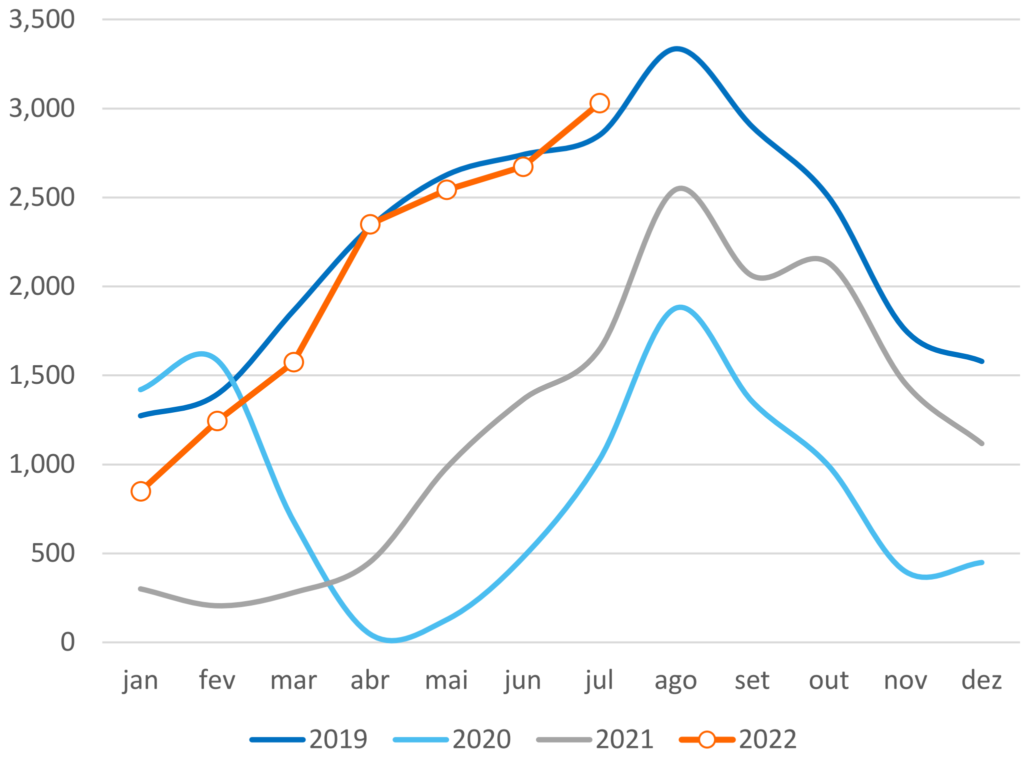
2 prices on the regulated market are lower than in the liberalized one because they are based on long-term contracts signed 20 years ago with Algeria and Nigeria and with a more stable price than the spot price.

- **These measures weight about 1% of GDP and does not put in risk the fulfillment of the Government's deficit target for 2022. The official target is 1,9% of GDP in 2022 and considering that the budget execution until July indicates that the deficit would end the year at around 0,8%.**
- **This program does not put pressure on public accounts, allowing the maintenance of the path of reduction of the debt ratio.** Indeed, one of the factors that would put most pressure on public accounts in 2023 - the update of pensions - will be mitigated with the probable approval of the revision of the calculation formula of the update factor, which aims to reduce by about half, ie instead of updates in the order of 8%, the update in 2023 will be around 4-4.5%.
- Up to the end of the month it is probably that Government announce support measures for corporates.

Tourism is recovering as Covid related restrictions were removed

Number of guests (foreign and national)

Thousand



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

Number of guests (foreign and national)

versus same period of 2019 (%)

	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q 22	jul-22
TOTAL	-83%	-64%	-31%	-19%	-19%	-2%	6%
United Kingdom	-97%	-80%	-61%	-35%	-21%	2%	6%
Germany	-93%	-84%	-57%	-17%	-26%	-4%	3%
Spain	-93%	-71%	-37%	-17%	-30%	-3%	5%
France	-91%	-83%	-31%	-28%	-15%	-11%	6%
Brazil	-96%	-93%	-86%	-52%	-44%	-27%	-28%
US	-98%	-94%	-63%	-40%	-15%	25%	32%
Others	-95%	-90%	-74%	-59%	-53%	-31%	-14%

- **Guests: in July the number of tourists surpassed the same pre-pandemic month (+6,3%), for the 2nd time this year.** The number of non-residents surpassed by the 1st time the 2019 level (+2,1%); resident tourists surpassed the numbers of 2019 (+13,3%), for the 4th month in a row**. In the 1S 22, the income from tourist accommodation establishments was 4,8% above 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 than in 2019).
- **Despite this good behavior, we only expect the sector to recover completely to above pre-pandemic levels in 2023.**

The real estate sector: resilience and solid fundamentals

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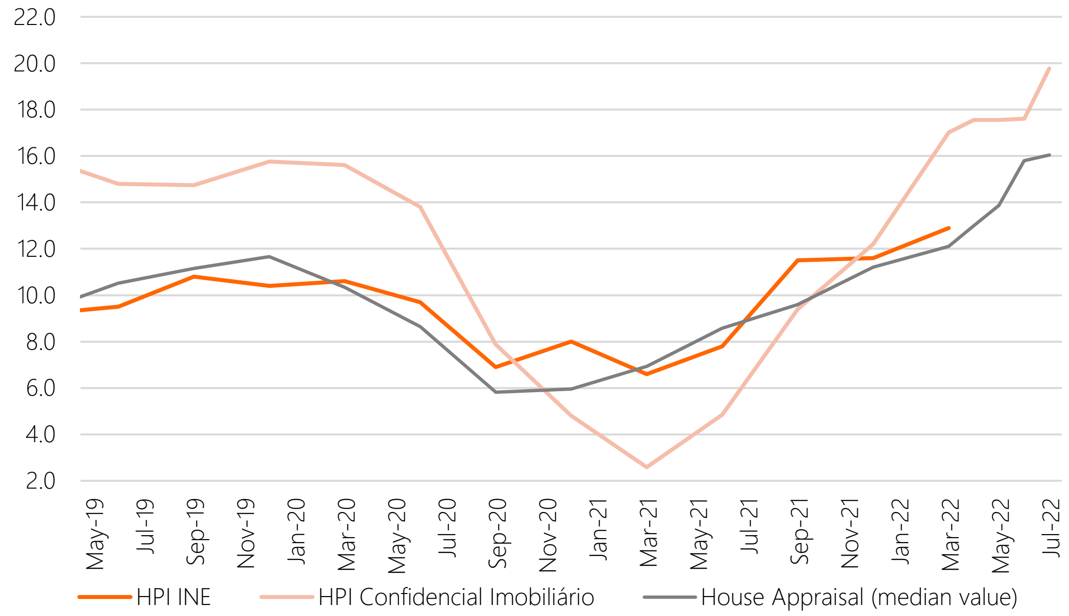
Housing prices

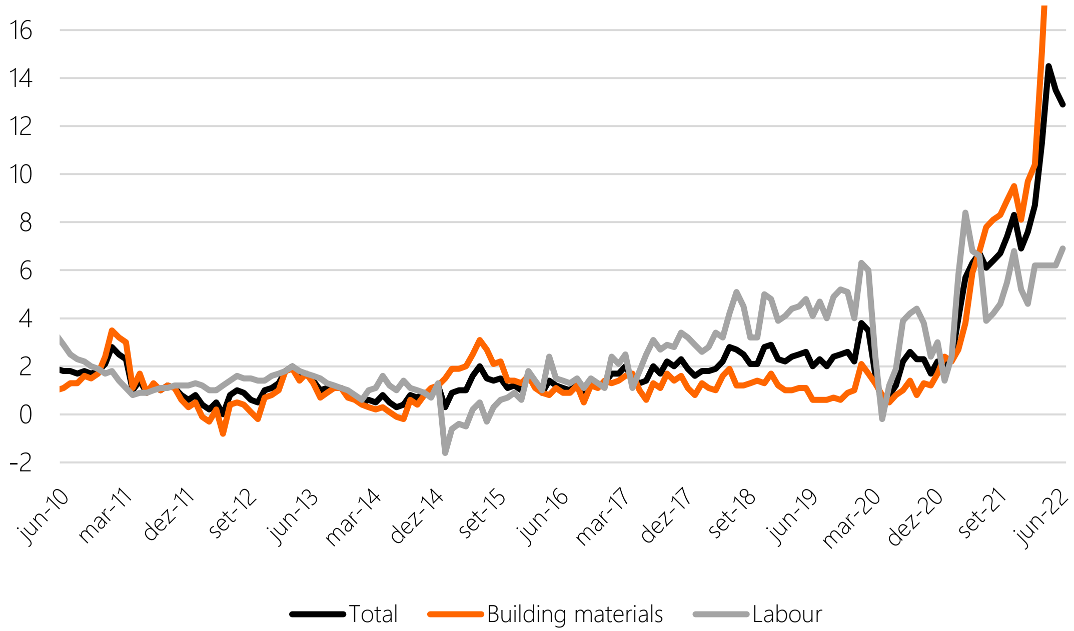
Year on year (%)



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

Construction costs index for new homes

yoy % change



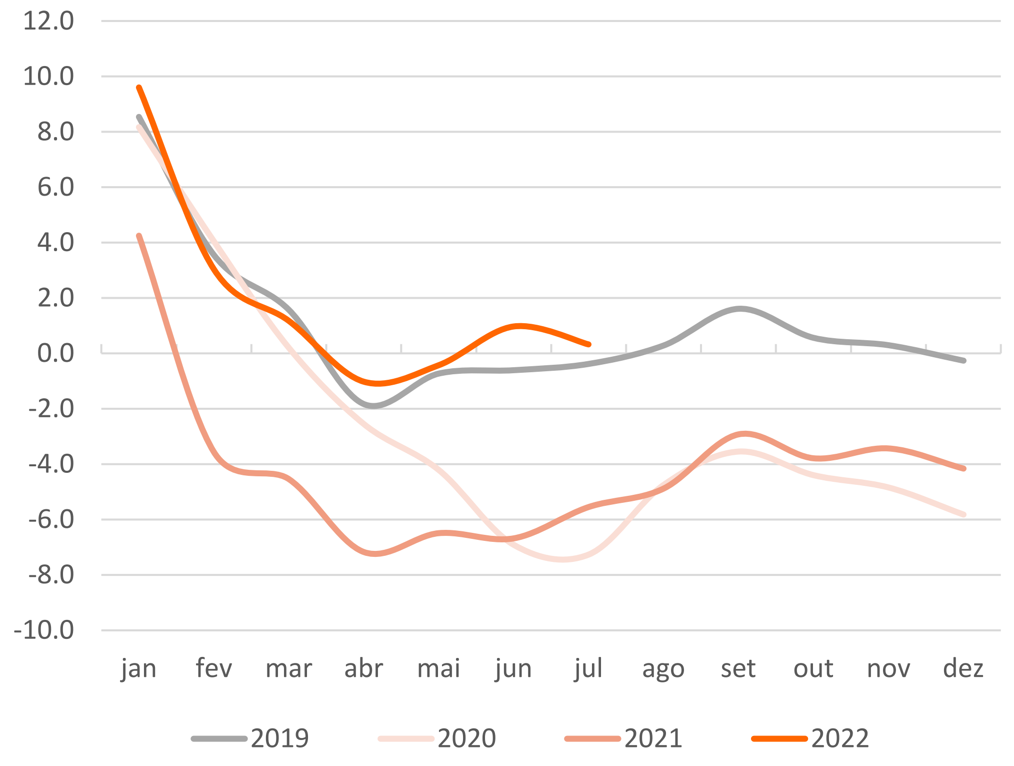
***Source**: BPI Research, based on INE data.*

- 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 and are expected to accelerate to around 10% in 2022. 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 CaixaBank Research.*

Budget execution (cash basis)

Year-to-date (% GDP, unless otherwise specified)

January-July	2019	2020	2021	2022	Var. 2022 vs 2019	Var.2022 vs 2021 (million euros)
Revenues	**39,7**	**38,0**	**39,1**	**41,8**	**2,1**	**7.731**
Tax Revenue	22,4	20,7	21,1	23,5	1,1	5.493
Social Security Contributions	10,1	10,7	10,9	11,0	0,9	1.292
Expenses	**40,1**	**45,2**	**44,9**	**41,4**	**1,4**	**142**
Personnel expenses	9,7	10,9	10,8	10,2	0,5	324
Current Transfers	17,3	20,2	20,2	18,3	1,1	-354
Acquisition of Goods and Services	5,5	6,0	5,6	5,8	0,3	764
Interests	4,3	4,2	3,4	3,0	-1,3	-263
Investment	1,8	2,2	2,6	2,4	0,5	-1
Budget Balance (cash basis)	**-0,4**	**-7,3**	**-5,8**	**0,3**	**0,7**	**7.589**
Budget Balance (accrual basis)	*+0.1*	*-5.8*	*-2.8*	*-1.7**		
Primary current expense	*36.7*	*42.1*	*41.9*	*40.4**		

Note (*): BPI. estimate

- Up to July, the public deficit (cash basis) stood below pre-pandemic levels, reflecting strong revenue growth and cost control.
- The strong labor market is contributing to the rise of revenues; and ultra-accommodative monetary policy as well as active debt management have been reducing the interest bill.
- Public debt (% of GDP) decreased by 7.7 p.p. to 127.4% in 2021 and to 125.6% in Q2, 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

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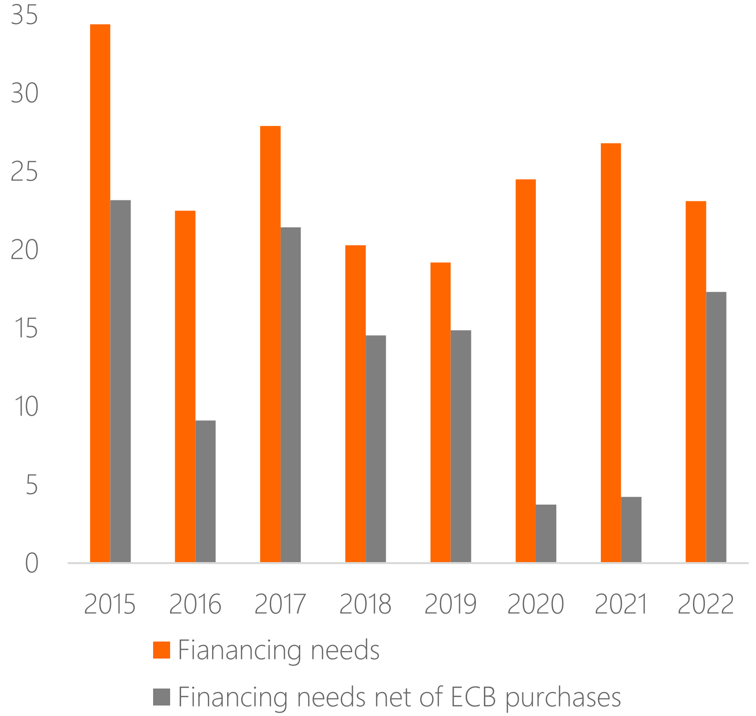
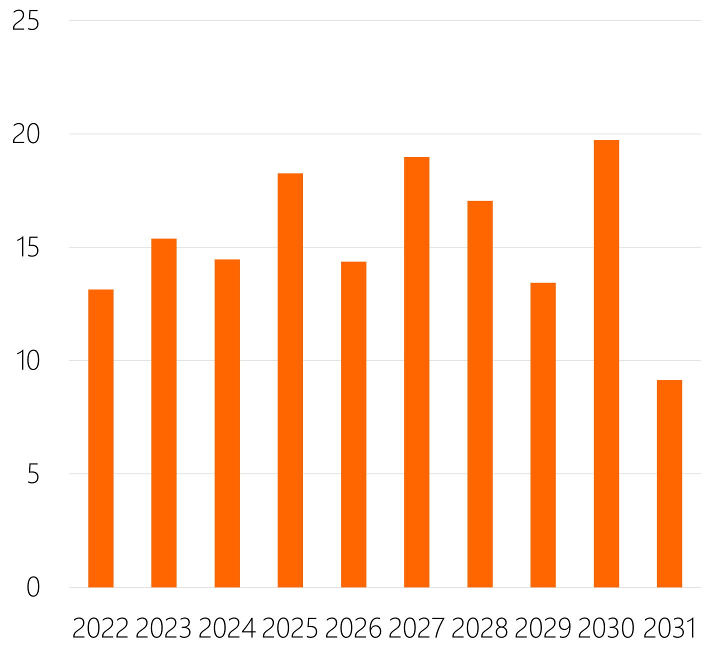
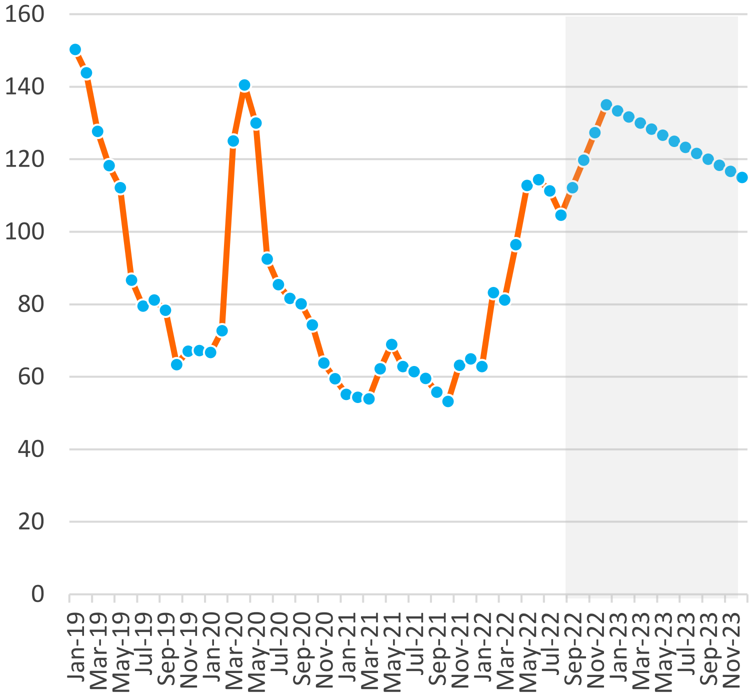
Funding needs
(Billion euros)



Portuguese Public debt Maturity Profile
(Billion euros)



Sovereign risk premium
b. p.



***Source**: BPI Research, based on DGO and Bloomberg; forecasts by BPI Research.*

- **Financing needs for 2022 amount to €23 bn, minus €4 bn than in 2021.** Up to the end of the APP and PEPP programs, ECB's net acquisition of Portuguese debt amounted to around €6 bn, circa 25% 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 €25 bn (c. 11% of GDP).
- 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. In July, the Treasury 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 supported also by the ECB new anti-fragmentation tool. Apart from active debt management, the solid macro fundamentals and positive evaluation from the several rating agencies, will probably also cushion risk premia going forward.

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

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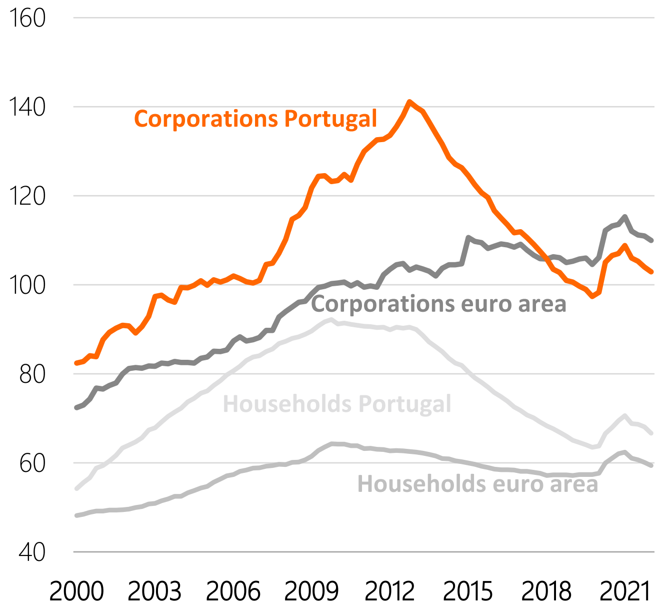
Gross private debt
% of GDP, non consolidated debt.

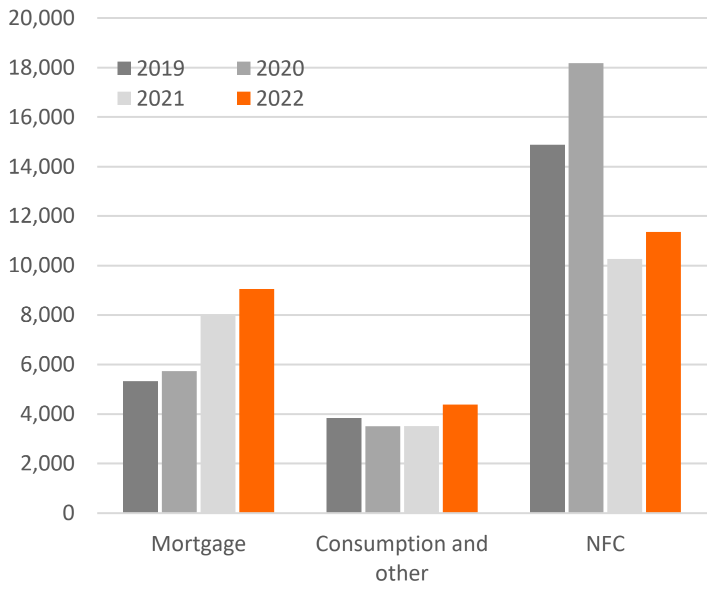


Source: ECB, Eurostat

Private domestic credit
Year on year (%)

	Jul 2021 % yoy	Jul-2022 % yoy	2022 (For.) % yoy
Credit to the non-financial private sector	**4.4%**	**2.1%**	**-0.9%**
Households	**3.0%**	**3.6%**	**0.7%**
Housing mortgages	**2.9%**	**3.7%**	**1.3%**
Other purposes	**3.3%**	**3.0%**	**-1.7%**
Consumer lending	**0.4%**	**7.2%**	**0.9%**
Non-financial corporations	**6.9%**	**-0.3%**	**-3.6%**

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



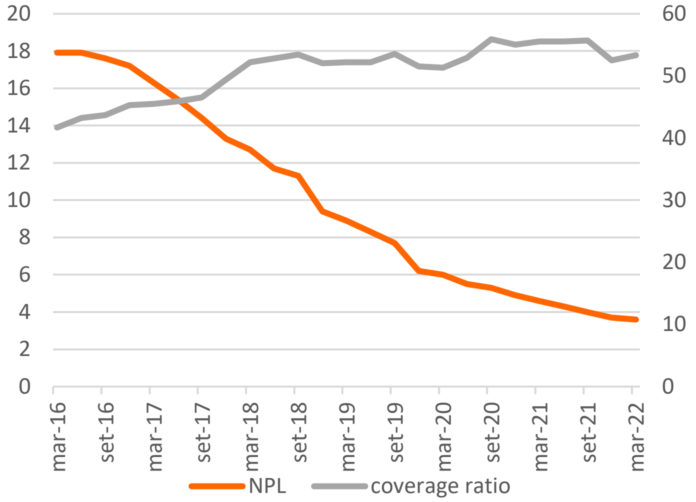
Source: Bank of Portugal

- **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.
- **Up to July 2022, new operations showed a positive trend:** new credit for NFC and households increased 10.6% and 16.4%, respectively. The dynamics was especially positive since March, and for NFC; mortgage credit continues very strong even if it is slowing down. However, interest rates 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 going forward. Regarding NFC, credit outstanding will decline due to the progressive maturity of Covid-credit lines and also due to moderate demand of new credit, as companies are constrained by high inflation and increasing interest rates.

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)

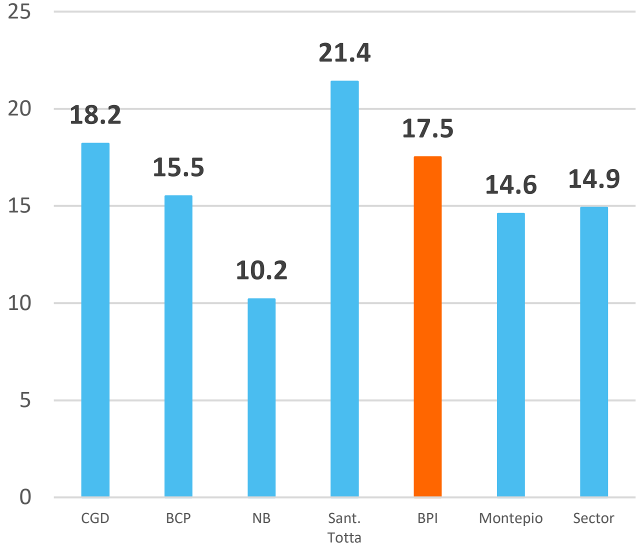
	BPI	BCP	San Totta	CGD	NB*	Montepio
Net interest income	**1.2%**	**1.3%**	**1.3%**	**0.7%**	**1.3%**	**1.2%**
Net fees	0.7%	0.8%	0.7%	0.5%	0.6%	0.6%
Gains on financial assets	0.1%	0.2%	0.5%	0.2%	0.4%	0.0%
Other net profits	-0.2%	-0.2%	-0.1%	0.0%	-0.3%	-0.1%
Gross income	**1.8%**	**2.2%**	**2.4%**	**1.6%**	**2.0%**	**1.7%**
Operating expenses	-1.2%	-1.2%	-1.0%	-0.5%	-0.9%	-1.4%
Operational result	**0.7%**	**0.9%**	**1.5%**	**1.1%**	**1.1%**	**0.3%**
Impairment losses, taxes and others	-0.2%	-0.8%	-1.2%	-0.5%	-0.5%	-0.7%
Profit	**0.4%**	**0.1%**	**0.3%**	**0.6%**	**0.6%**	**-0.4%**
ROTE[1]	5.9%	0.4%	3.5%	7.2%	nd	nd

[1]average 4 quarters; for BCP and CGD data available is for ROE
* Q4 2020

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 expected path for 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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