Portugal:
Macroeconomic and financial outlook

BPI *Research*

November 2022

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BPI Grupo CaixaBank

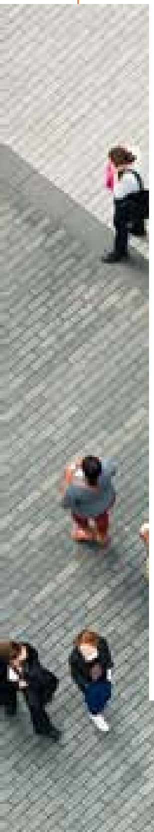
Main messages

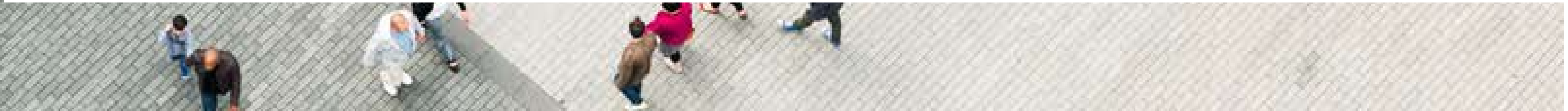
Activity

- **GDP advanced 0,4% and 4,9% yoy in Q3, the stronger yoy growth within EMU.** By end Q3, GDP stood 2,4% above the pre-pandemic level and annual growth in 2022 should surpass our current forecast of 6,3%. 2023 it will be a tough year due to the existence of strong headwinds coming from higher inflation and interest rates, but a recession should be avoided as Portugal is less vulnerable than central and northern Europe to high energy prices as the proportion of renewables in the primary energy mix is higher, dependence on Russian gas is low (2021: total energy imports from Russia represented 8% of total energy imports), and also due to the capacity to receive LNG (port of Sines) and due to the existence of long term contracts with different gas providers. Comparatively less heavy, energy intensive industrial sector is also a plus in the current scenario.
- **Inflation accelerated in October to 10,2%,** and is expected to remain pressured until first months 2023 due to the pressure in energy prices and contagion to other goods.
- **High frequency indicators related to the tourism sector confirm the strong summer season.** The number of airline tickets issued to Portugal in recent months has been higher than in 2021, suggesting that the sector will continue to recover in the coming months.
- **Housing prices accelerated further in Q2 (3,1% qoq and 13,2% yoy), consolidating expectations of an annual rise above 10%.** But tighter financial conditions should be reflected in demand, especially in 2023. In this sense we expect a small decline on prices next year.
- **Public accounts are having a very good performance, one of the factors behind recent improvement of sovereign debt risk evaluation (rating improved by one notch, S&P's and Fitch to BBB+, DBRS to A).** On a cash basis, public balance registered a surplus: 3% of GDP, which compares to -2,9% and +1,6% in the same period of 2021 and 2019, respectively.
- **State Budget for 2023, still under discussion, keeps the focus on fiscal consolidation and is based on prudent macro assumptions.** Pubic deficit is expected to decline to 0,9% of GDP from 1,9% in 2022 (our estimate suggest that could be better than expected) and the public debt ratio should decline to 110,5% of GDP from 115% in 2022. For 2022, the fiscal deficit is expected to decline to 1,7% of GDP (2,8% in 2022). 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 €29 bln (≈13% of GDP), a new maximum since 2018: €27 bln.

Banking Sector

- **Credit quality indicators improved further in Q2 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. Additionally, the strong position of the labour market, expected to worsen only moderately, and the improved position of households and firms in terms of leverage, also suggest that the interest rate impact on credit quality might be moderate, in a context of a strong position of the banking sector.





Main economic forecasts

									Forecasts	
%, yoy	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
GDP	0.8	1.8	2.0	3.5	2.8	2.7	-8.3	5.5	6.3	0.5
Private Consumption	2.5	1.9	2.6	2.1	2.6	3.4	-6.9	4.7	5.0	0.5
Public Consumption	-0.5	0.8	0.8	0.2	0.6	2.1	0.4	4.6	2.0	-0.2
Gross Fixed Capital Formation (GFCF)	2.3	5.9	2.5	11.5	6.2	5.4	-2.2	8.7	1.7	3.8
Exports	4.3	6.2	4.4	8.4	4.1	4.1	-18.8	13.5	16.5	4.3
Imports	8.1	8.1	5.0	8.1	5.0	4.9	-11.8	13.3	10.1	5.0
Unemployment rate	14.5	13.0	11.4	9.2	7.2	6.6	7.0	6.6	5.9	6.4
CPI (average)	-0.3	0.5	0.6	1.4	1.0	0.3	0.0	1.3	7.9	5.7
External current account balance (% GDP)	0.2	0.2	1.2	1.3	0.6	0.4	-1.2	-1.1	-2.7	-2.3
General Government Balance (% GDP)	-7.4	-4.4	-1.9	-3.0	-0.3	0.1	-5.8	-2.9	-1.5	-1.3
General government debt (% GDP)	132.9	131.2	131.5	126.1	121.5	116.6	134.9	125.5	115.6	113.4
Risk premium (PT-Bund) (average)	252	189	307	269	138	98	89	60	104	124

***Source**: BPI Research*

Energy mix with more renewables provides a buffer against volatile environment

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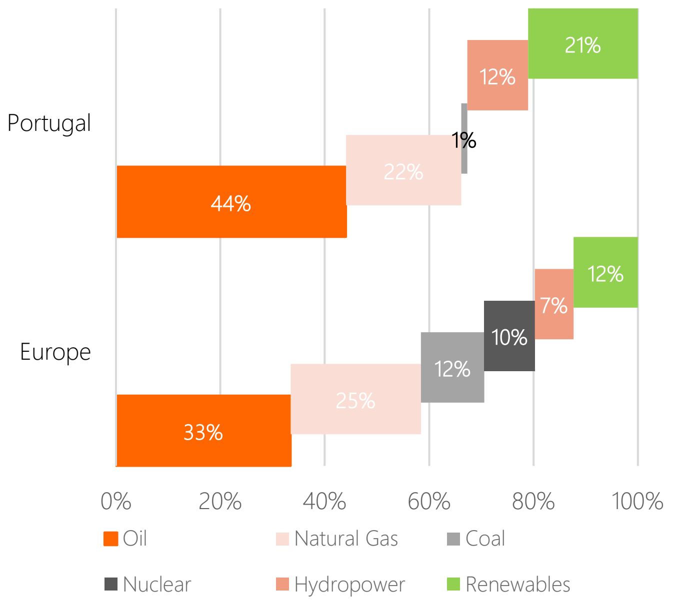
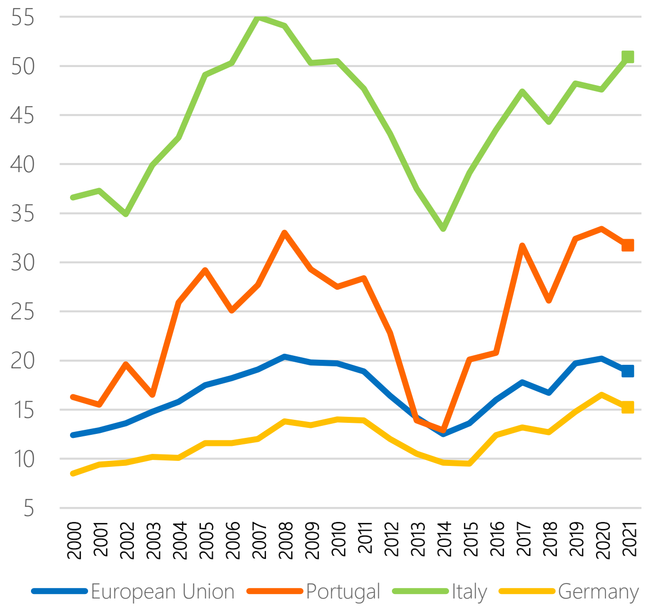
Primary energy source
%



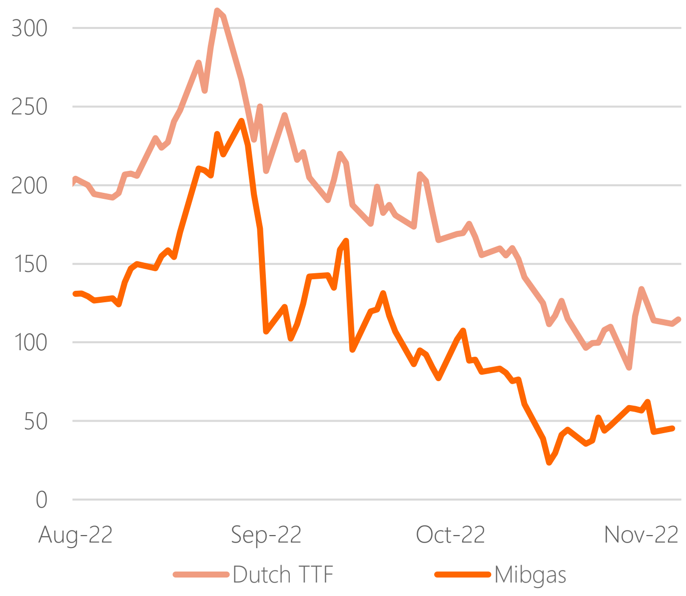
Source: BPI Research, using data from Our World in Data,

Share of electricity generated by gas
%



Source: BPI Research, using data from Our World in Data,

Natural gas price: Dutch TTF *versus* Mibgas
Eur/MWh



Source: BPI Research, using data from Bloomberg,

▶**Compared to the rest of Europe, Portugal is more dependent on oil as a primary energy source (44%).** On the other hand, the energy component via renewable energies is also substantially higher.

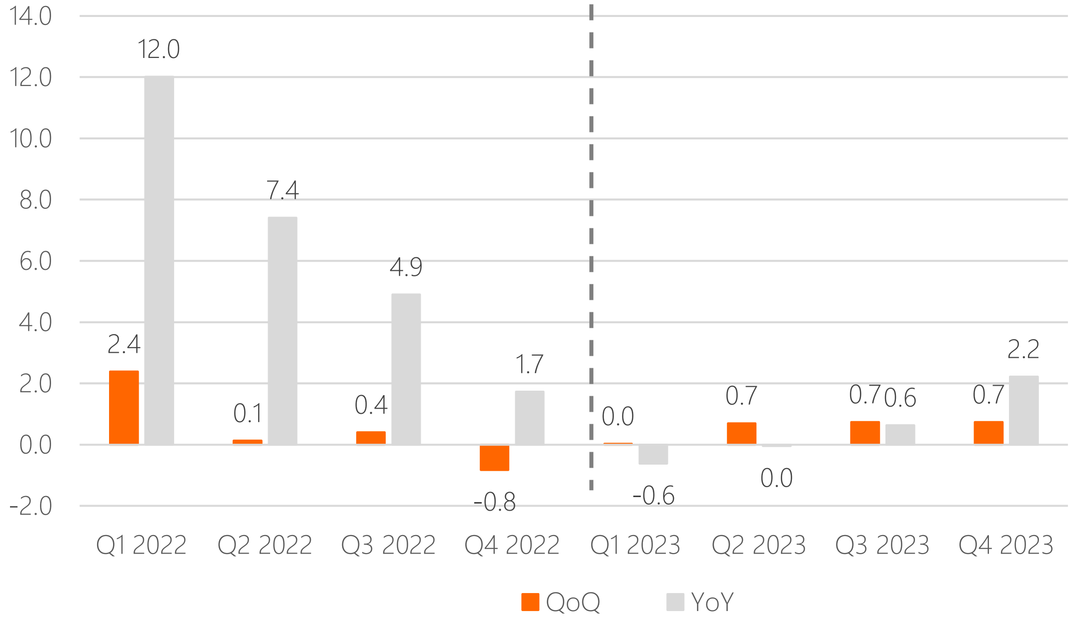
▶**In 2021, natural gas was the source of 31,7% of the electricity produced**, meaning that the country is also exposed to the price of gas, which has experienced a sharp increase on international markets in the context of geopolitical tension with Russia and war with Ukraine (in March 2021 Dutch TTF, the European benchmark for gas, was trading gas at ≈ 17 eur/MWh and in the end of August 2022 the price peaked to 311 eur/MWh. It is now trading at around 160 eur/MWh).

▶Despite what is stated in the previous point, **the reference gas price in the European market (Dutch TTF) has been significantly higher than the reference price in the Iberian gas market (Mibgas).** The difference is justified by the fact that the closure of gas pipelines in Russia has turned the European gas market into a market with a preponderance of LNG (liquefied natural gas). Unlike the Iberian Peninsula, which has ample capacity to receive LNG, the rest of Europe does not have sufficient infrastructure to receive and gasify the gas it needs. The lack of adequate gas and electricity interconnection between the Iberian Peninsula and France causes this gap to persist.

GDP: better than expected Q3, but clouds over 2023 remain dark

GDP Growth: last readings and forecasts

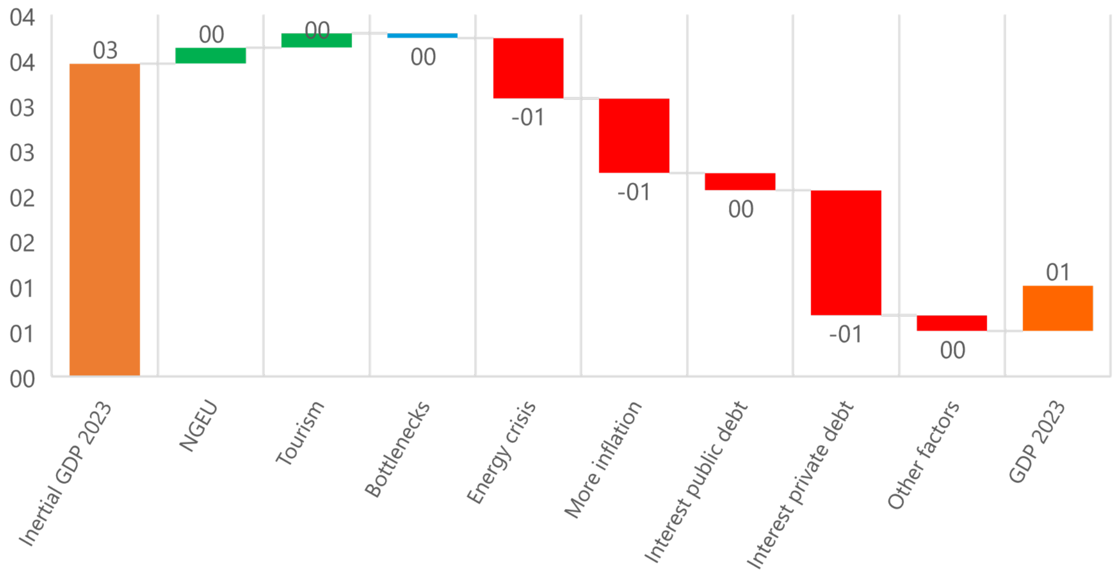
Yoy, level



Source: *BPI Research, from INE*

Growth 2023: strong headwinds will curb growth

Percentage points



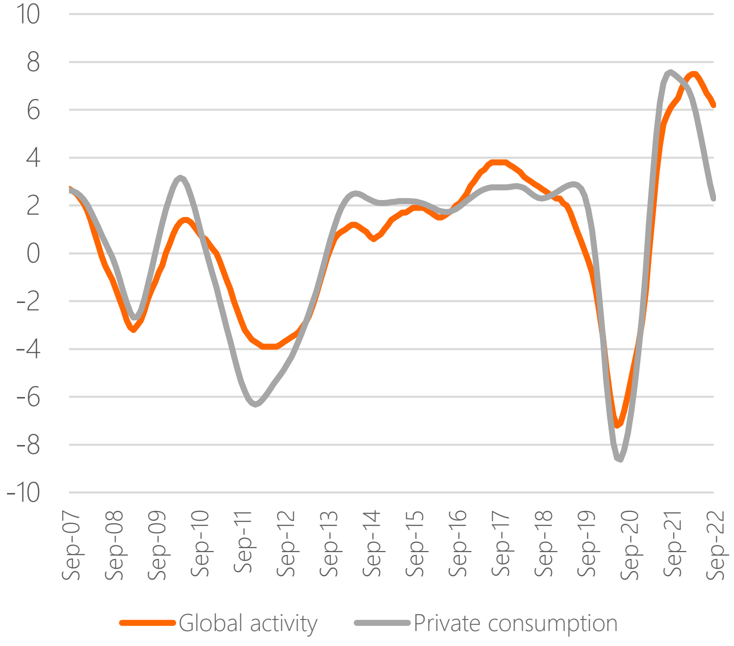
NOTE: "Inertial" GDP 2023 refers to the level which would result from not considering the extraordinary effects arising from the war in Ukraine and inflation. It was obtained through regression of annual GDP growth with its autoregressive component and the output gap released by the IMF in the WEO Oct 2022.

- **Growth surprised on the upside in 3Q22**: GDP increased 0.4% vs. our forecast of 0.1%; this together with upward revisions to the historical series by INE, means a strong likelihood that growth in 2022 will exceed 6.3%. Our annual forecast accommodates a quarterly decline close to 1,5% in 4Q22, which seems very unlikely, though indicators are decelerating. At the end of 3Q, GDP exceeded the pre-Covid level by 2.4% (in 2Q exports of goods and services exceeded the 2019 level by 10% year-on-year).
- **For 2023, we expect a strong deceleration of activity,** reflecting the impact of the energy crisis in Europe and strong headwinds coming from higher interest rates; inflation is expected to remain high due to persistently high energy prices and contagion to other goods; unemployment should rise a bit reflecting the strong deceleration of activity. Hence, despite the tailwinds due to the still comfortable position of households in terms of excess savings and also derived from the stimuli coming from the execution of NGEU, we consider that the increase in interest rates, the persistence of high inflation and the negative impact of the energy crises on external demand will prevail, causing significant deceleration of economic activity.
- The scenario is subject to a high degree of uncertainty that, for now, seems to be biased on the negative side. Indeed, if the winter is colder than usual, if energy saving measures are not efficient or if there is any disruption on the gas alternative suppliers and flows in Europe, a scenario of energy rationing in Northern Europe might be needed, with negative consequences for economic growth. Additionally, but still a risk is the possibility of new virus waves, with negative consequences for growth.

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

Coincident indicators

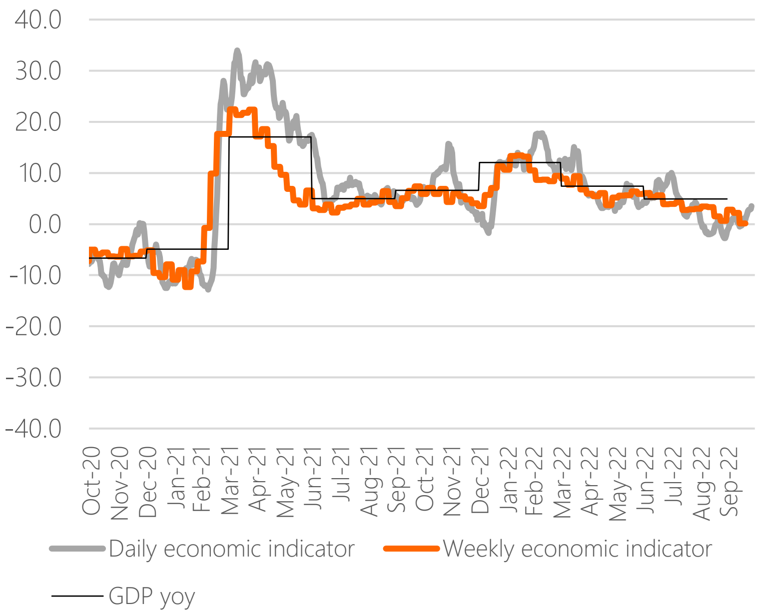
%



Source: BPI *Research, from INE*

GDP & high frequency indicators

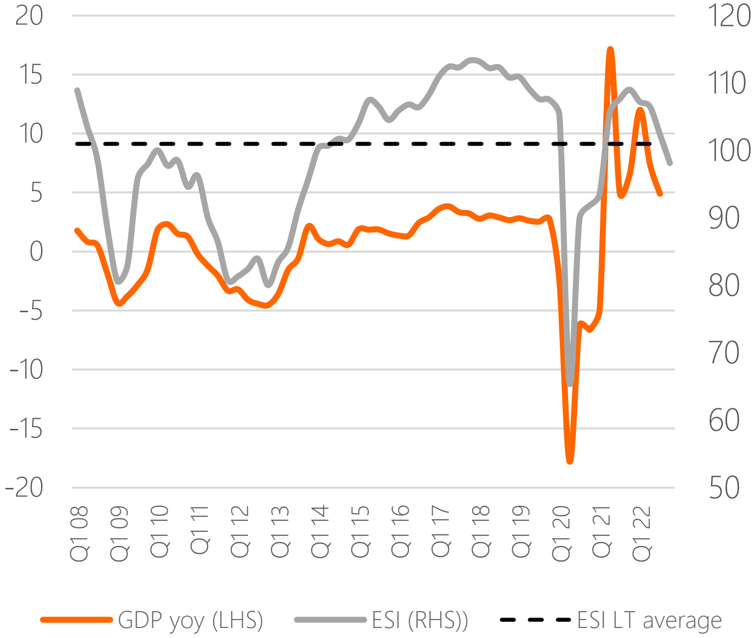
%



Source: *BPI Research, from BoP and EC*

GDP & EC Sentiment indicator

Yoy, level



- **Composite indicators are showing strong deceleration in the final months of 2022**. According to the coincident indicators calculated by Bank of Portugal, weakness in private consumption will be an important driver of economic deceleration. Nevertheless, data related with tourism continues strong and giving some support to growth.
- High frequency indicators and economic sentiment points to further deceleration closer to year end.
- The Economic sentiment indicator calculated by the European Commission fell to 98,1 in October, below the long term average of 100, an additional signal of weakness ahead.

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

Coincident indicators

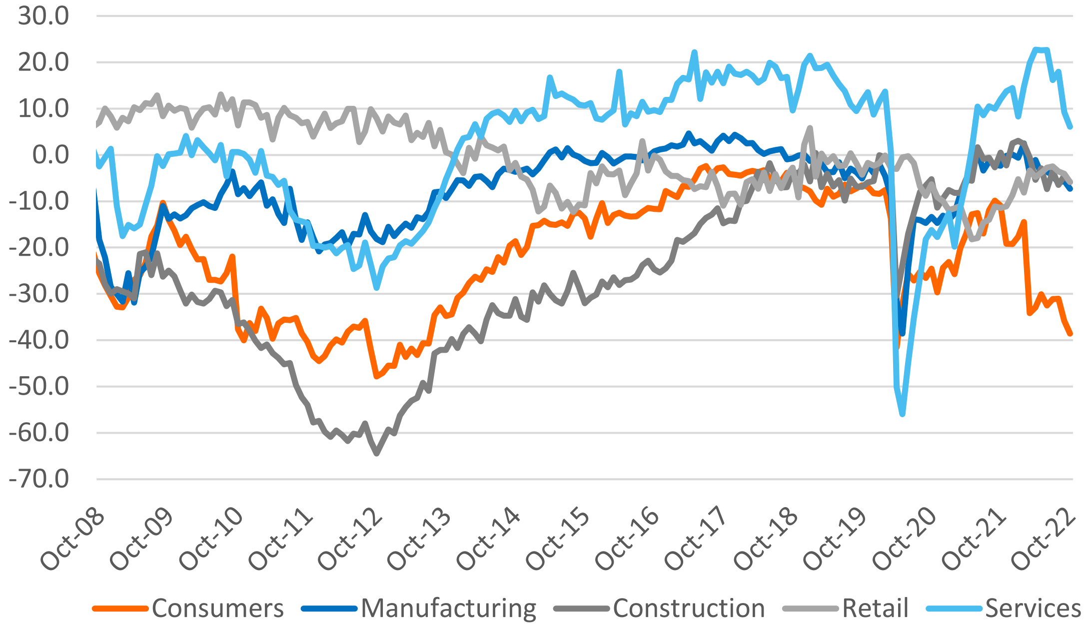
% qoq

	Q3 2022	Q2 2022	Last month
Employment (change 1000 individuals)	27,3	0,9	September
Unemployment (change 1000 individuals)	7,0	-9,6	September
Retail sales, excl. fuels	0,1	0,7	September
Car sales *(ACAP)*	-6,5	-0,9	October
Exports of goods *(yoy)*	28,0	31,1	September
Overnight stays *(yoy same month 2019)*	2,5	-1,7	September
ESI *(historical average ~100)*	100,3	105,4	September

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

Confidence indicators

Level



- **Consumption is slowing down, but with no signals of an abrupt weakness. Robust labour market and households accumulated savings during the pandemic,** (~3% of GDP) will contribute to partially accommodate at least some of the adverse impact of higher inflation and higher interest rates in the coming quarters. Indeed, it should be recalled that most of these savings are probably more concentrated in top-income households with lower propensity to consume. Even if that is the case, this should provide at least a buffer to the evolution of private consumption going forward.
- **Sentiment indicators**: Consumers confidence fell to levels close to ones seen in the sovereign debt crisis suggesting more precautionary behavior ahead, in line with our scenario; sentiment in services, industry, construction and retail is deteriorating too, but at a much slower pace.

Labor market remains robust but there are signs of less appetite for hiring

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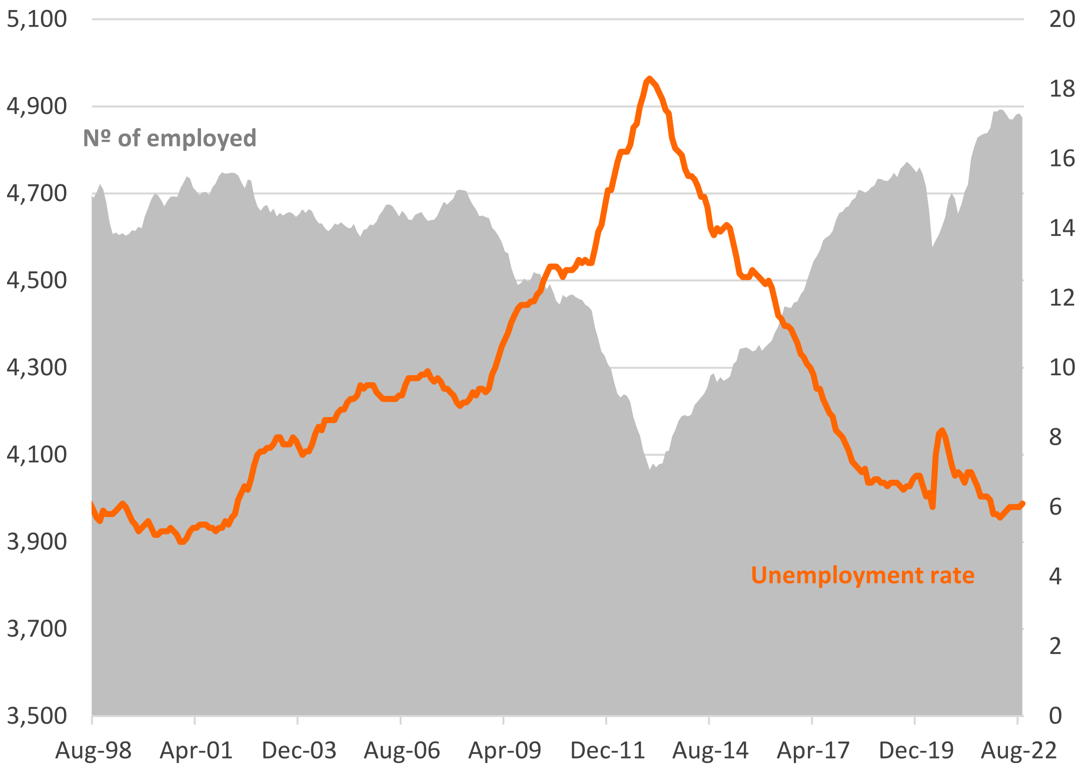
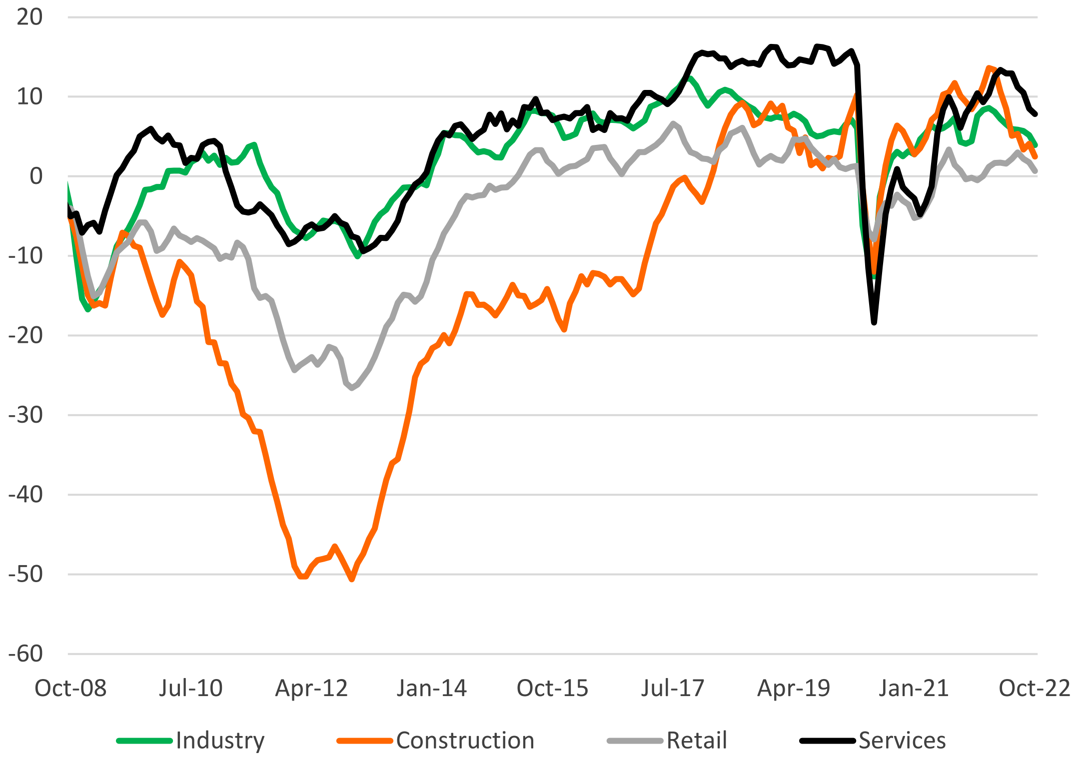
Employed population and unemployment rate
Thousand people *(%)*



Source: *BPI Research, from INE.*

Employment perspectives for the next 3 months
Level



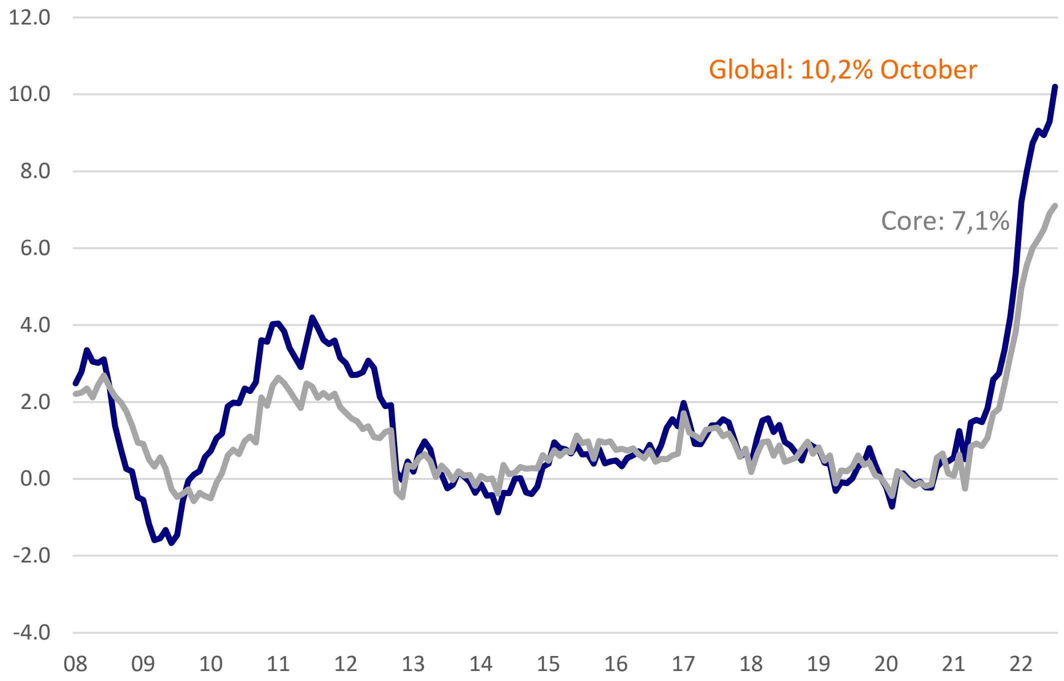
Source: *BPI Research, from INE.*

- **Labor market remains robust, but there are some signals of reversal.** Registered unemployment decreased in chain for the second consecutive month in September, the unemployment rate increased to 6.1% (from 6.0% in the last three months) and the employment perspectives for the next 3 months by sector are decreasing.
- **However, employment continues at high levels, confirming the tight labor market**. This is reflected in difficulties in hiring, mentioned by some sectors as an obstacle for the activity.

Inflation: global inflation surpasses 10% and the period of high inflation will probably be longer

The global and core inflation

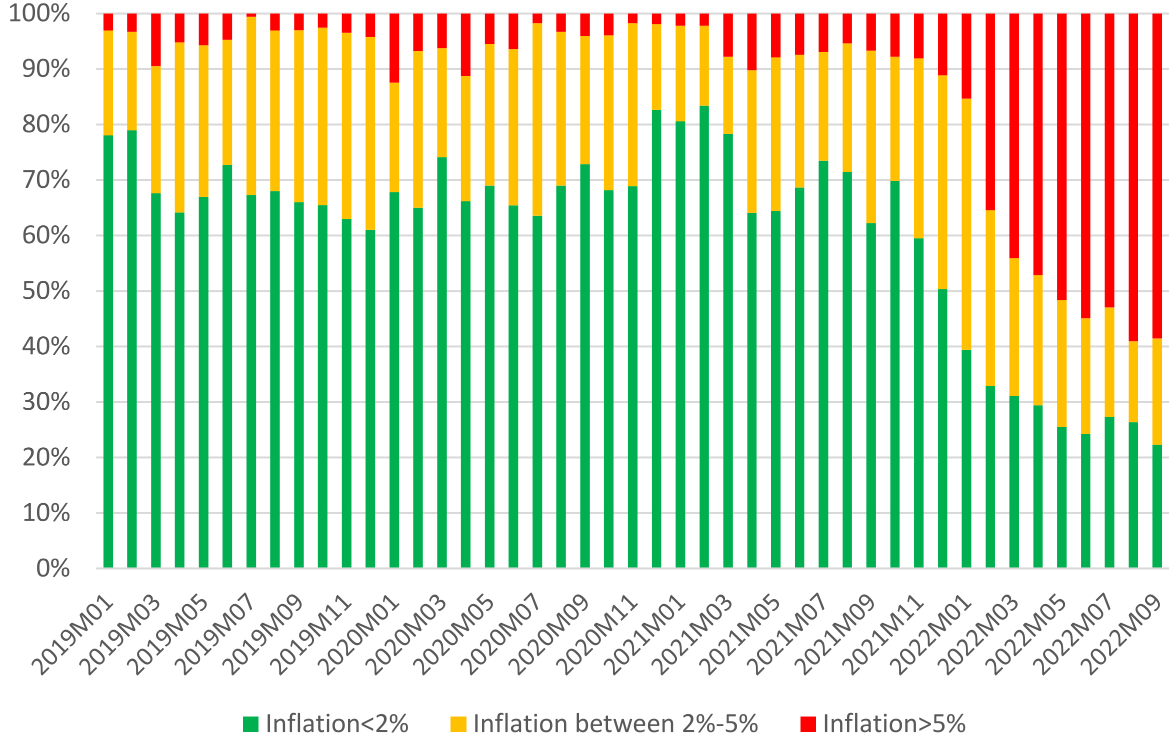
Year-on-year (%)



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

The inflation traffic light

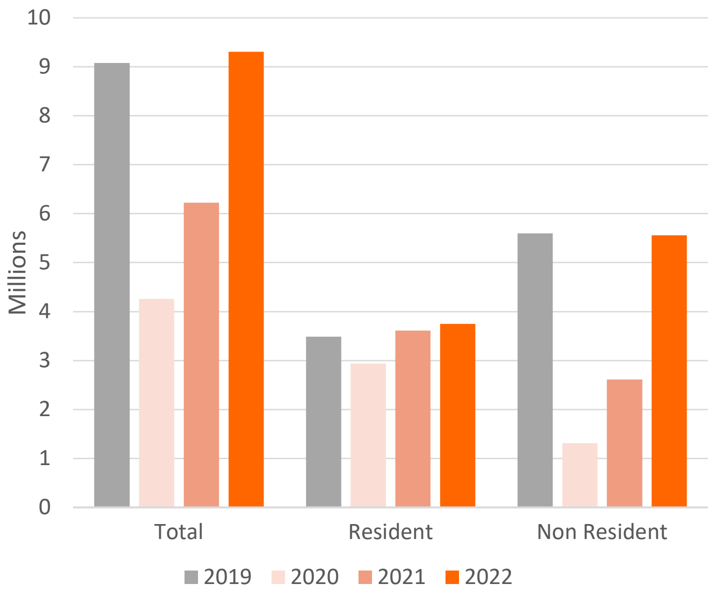
% of CPI basket



- **Inflation accelerated** to 10,2% in October from 9,3% in September; energy prices accelerated again in October, speeding up the spread to other goods. Core inflation accelerated to 6,9%, from 6,5%.
- **Given the expectation that pressures will continue in some commodities' prices (energy and food) inflation is foreseen to remain higher during more time.**

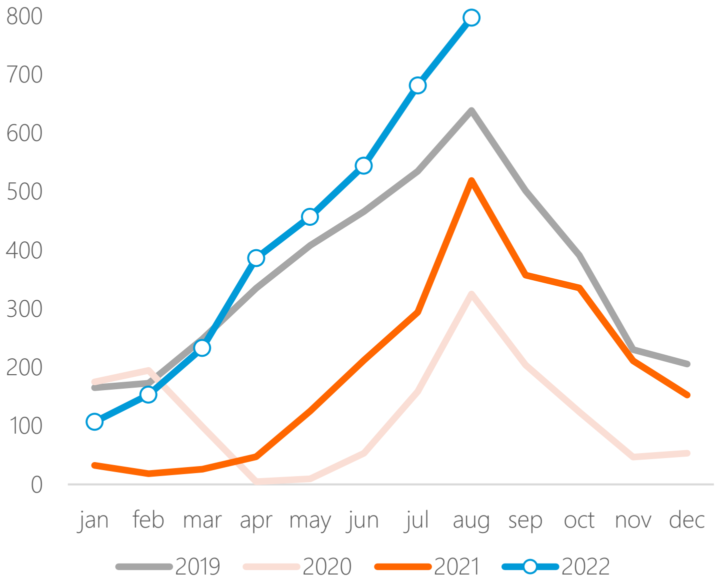
Tourism heading to pre-pandemic standards

Portugal: number of guests
Sum of Q3



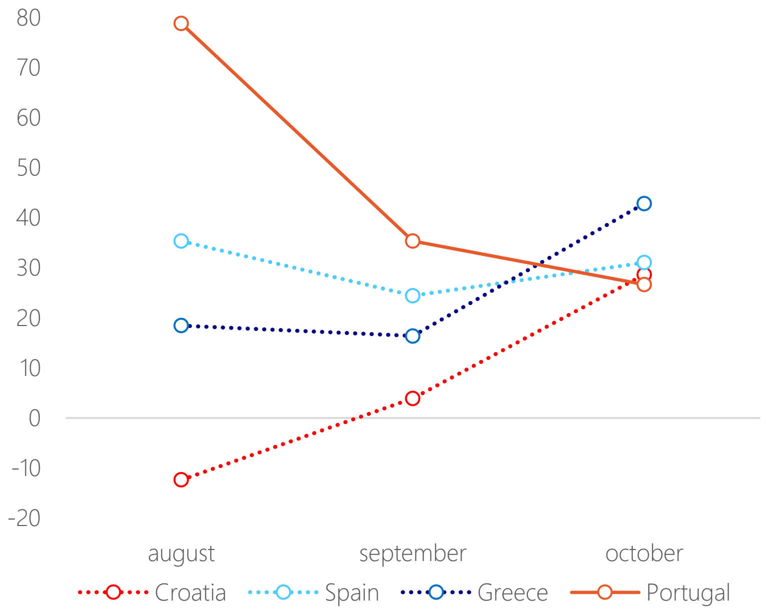
Source: *BPI Research, using data from INE.*

Revenue at tourist accommodation establishments
Million euros



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

Airline tickets issued to Portugal and competitors
Yoy versus 2021 (%)



Source: *BPI Research, using data from Turismo de Portugal and ForwardKeys.*
Note: *Tickets issued in the global distribution systems, for travel within the next 365 days, for Portugal and competing markets. Values subject to change due to postponements or cancellations. Excluded from this data are tickets booked directly with Low-Cost companies.*

- **2022 Q3 was quite positive for the tourism sector in Portugal.** The overall number of guests was over 9.3 million and exceeded those of the same period of 2019. By type, the same happened in residents but not yet in non-residents (-0,6%). Still, non-residents showed a significant recovery compared to 2021 (+112,7%).
- With this performance, we expect the number of tourists visiting Portugal in 2022 to be around 96% of the pre-pandemic level and this to be slightly exceeded next year.
- **Up to august, the revenues at tourist accommodation establishments surpass the same period of 2019 by 13%.** August 2022 was the month in which both revenue (796 million euros) and guests (3,37 million) were the highest ever.
- **The number of airline tickets issued to Portugal in recent months has been higher than in 2021**, suggesting that the sector will continue to recover in the coming months. In October, for the first time since the outbreak of the pandemic, the number of flights in Portugal was higher than in 2019.

Housing market: strong in 2022 but some signs of market slowdown

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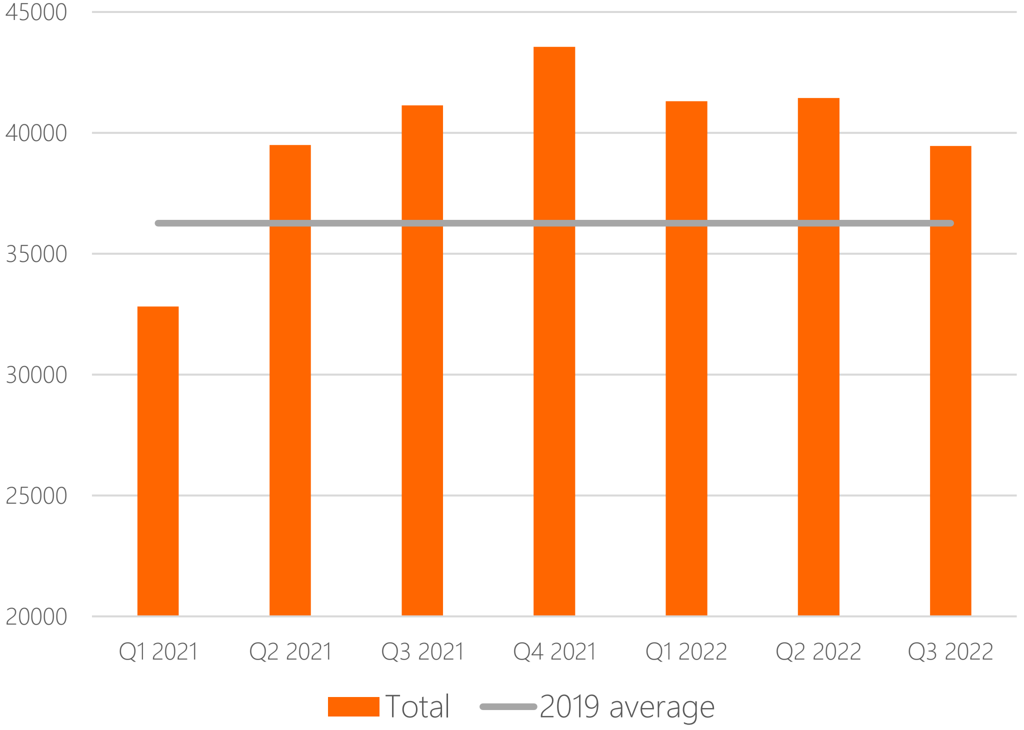
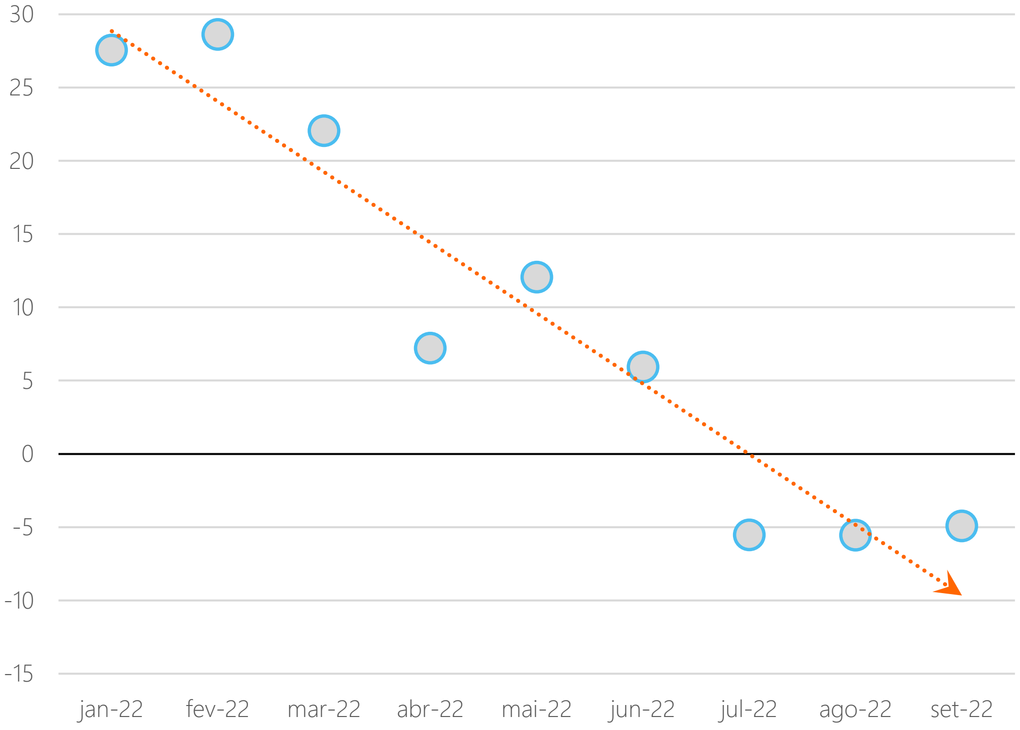
Houses sold
Number



Source*: BPI Research, using data from Confidencial Imobiliário.*

New loans for house purchase
Yoy change (%)



Source*: BPI Research, using data from Bank of Portugal.*

- **In 2022 we expect an average housing valuation of 11.7%:** recent data from Confidencial Imobiliário continues to show strong appreciation of residential property in Q3 2022 (+21%yoy in august). Factors such as the increase in purchases by people with tax domicile outside Portugal, rising construction costs and a "tight" property supply have been major price supports and will continue to shape the market going forward.
- **The most recent data from number of sales shows a quarter-on-quarter and year-on-year decrease (-4,7% and -4,1%, respectively).** Although the number of sales is still historically high and above the pre-pandemic quarterly average, this data could signal the beginning of a cycle reversal that should be seen more clearly from Q4 2022 onwards.
- **The interest rate hike is being stronger than expected and that is already reflecting in new loans for house purchase that are down in September for the third consecutive month (on a year-on-year basis).** Tighter financial conditions should be reflected in demand, especially in 2023. In this sense we expect the average valuation of properties to be negative next year (-1.5%).

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

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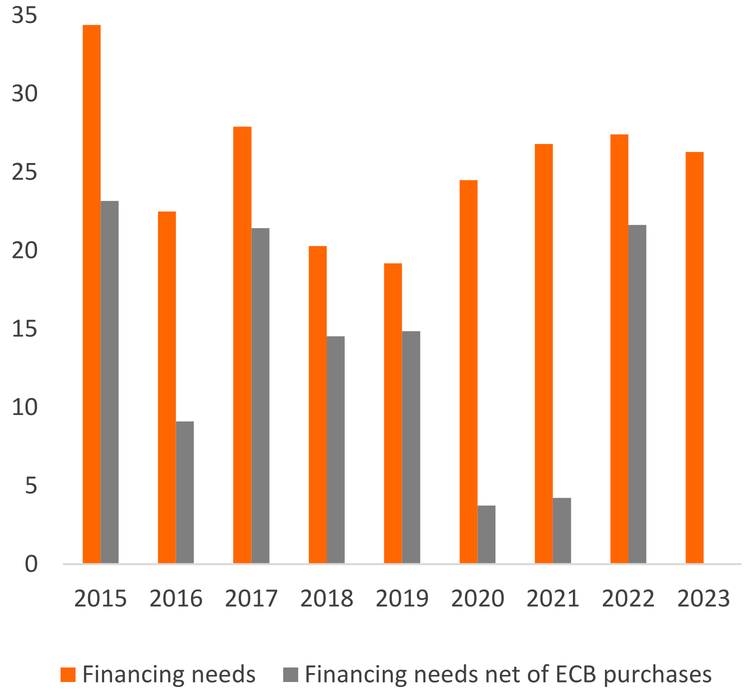
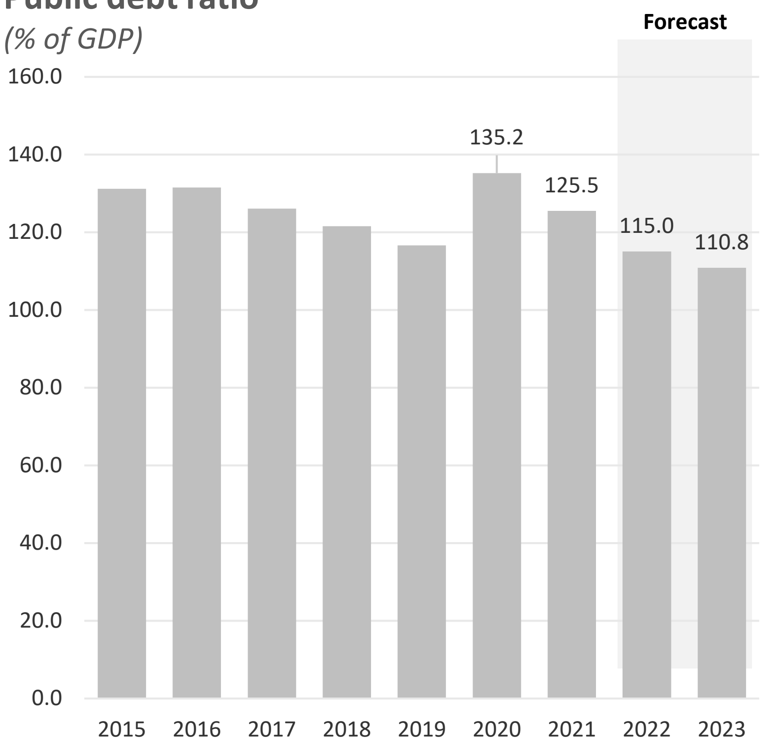
Funding needs
(Billion euros)



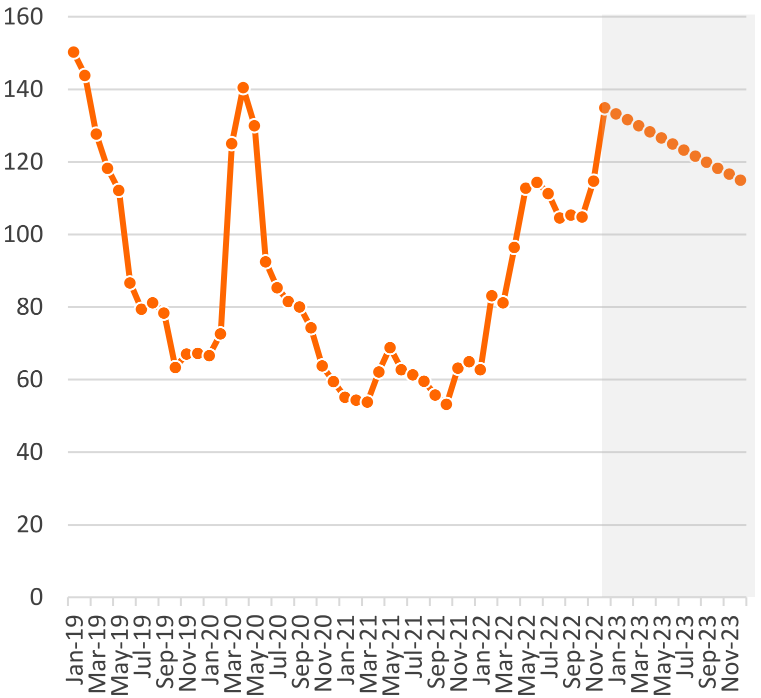
***Source**: BPI Research, based on DGO and state budget 2023.*

Public debt ratio
(% of GDP)



***Source**: BPI Research, based on state budget 2023 and INE.*

Sovereign risk premium
b.p.

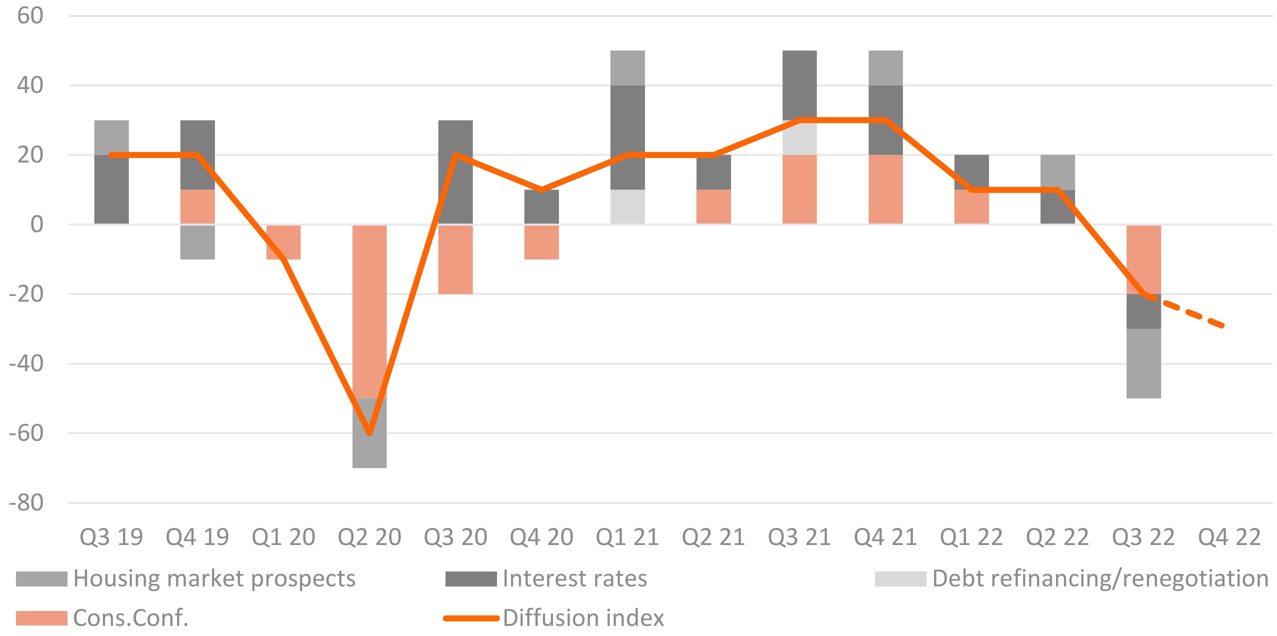


- **Financing needs for 2022 amount to €27 bn and are expected to decline to €26 bn in 2023.** Up to the end of the APP and PEPP programs, ECB's net acquisition of Portuguese debt amounted to around €6 bn, circa 25% of financing needs in 2022, pushing net financing needs not covered by the ECB to pre 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 positive evaluation from the several rating agencies and the strong sign given by the Government regarding fiscal consolidation and reduction of the public debt ratio, will probably also cushion risk premia going forward.

Banking system: a solid position to face the economic slowdown (1)

Diffusion index – demand for mortgage credit

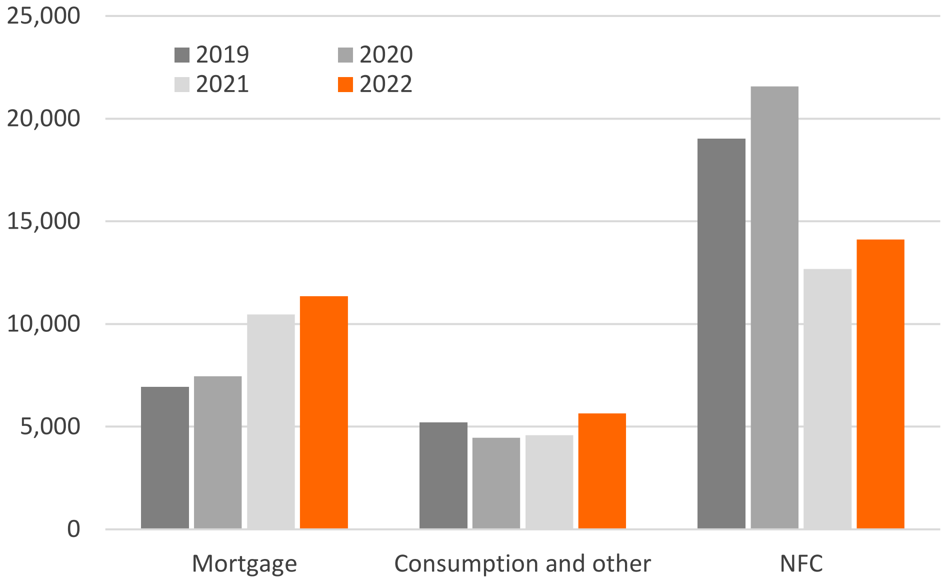
Index



Source: *BPI Research, base on data from Bank of Portugal.*

New lending activity by sector

Accumulated in the year (up to September), Bn

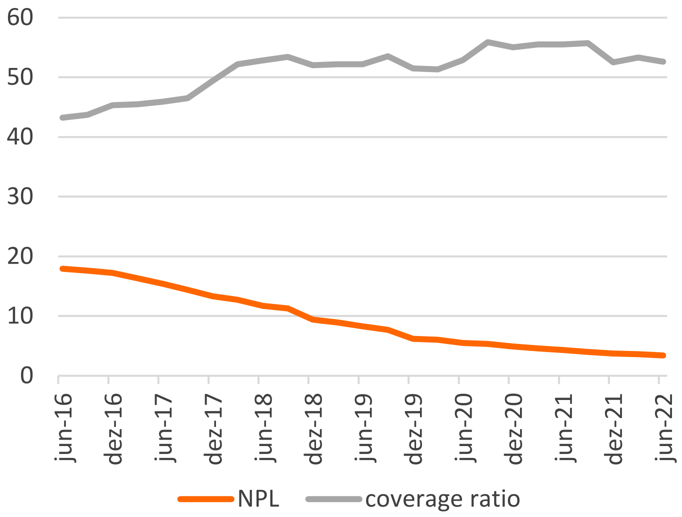


Source: *BPI Research, base on data from Bank of Portugal and ECB.*

- **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.
- **New credit started to decelerate.** Up to September 2022, new financing for NFC and households increased (11.3% and 13.0%, respectively), but is showing signs of deceleration. In fact, looking at September, new mortgage credit decreased almost 5% yoy, and reaches the levels of the beginning of this year; however, new production continues at higher levels than the average seen in 2019. For NFC, the amount increased in September.
- **Banks are anticipating lower demand for credit in Q4**. Increasing interest rates, higher inflation rate and lower confidence should cool down 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' budgets are constrained by high inflation and increasing interest rates, and investment projects are postponed.

Banking system: a solid position to face a decelerating activity (2)

NPLs and coverage ratios



Cost of risk[1]
0.5% in 2019
0.2% in Q2 2022

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

Banks' profitability

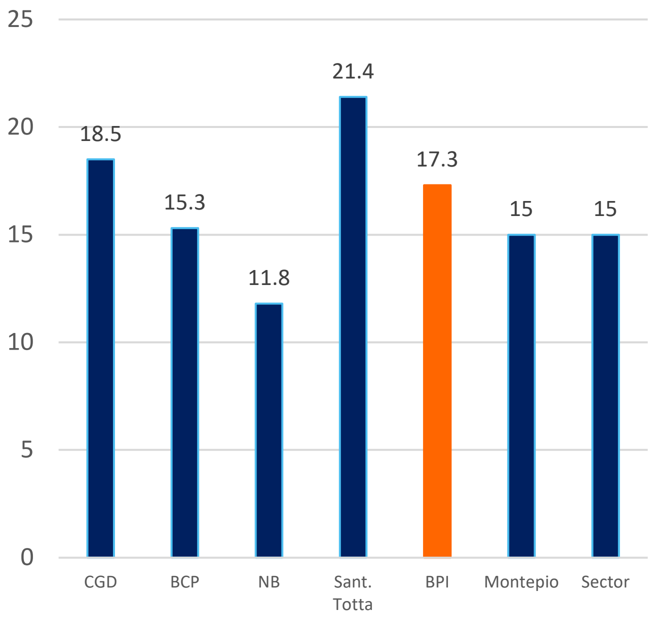
In % of average total assets (H1 22; trailing 12M)

	BPI	BCP	San Totta	CGD	NB	Montepio
Net interest income	**1.1%**	**1.3%**	**1.2%**	**0.8%**	**1.2%**	**1.2%**
Net fees	0.7%	0.8%	0.8%	0.5%	0.6%	0.6%
Gains on financial assets	0.1%	0.2%	0.1%	0.1%	0.4%	0.2%
Other net profits	-0.2%	-0.2%	-0.1%	-0.1%	0.2%	-0.2%
Gross income	**1.8%**	**2.2%**	**2.0%**	**1.4%**	**2.4%**	**1.8%**
Operating expenses	-1.1%	-0.9%	-0.8%	-0.8%	-0.9%	-1.2%
Operational result	**0.7%**	**1.3%**	**1.2%**	**0.7%**	**1.5%**	**0.6%**
Impairment losses, taxes and others	-0.1%	-0.6%	-0.1%	0.5%	-0.1%	-0.1%
Profit	**0.4%**	**0.5%**	**0.8%**	**0.8%**	**1.2%**	**0.2%**
ROTE[1]	9.0%	2.8%	10.5%	11.5%	nd	nd

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

Banks' solvency and liquidity position

In % (Q2 22)



***Source**: Banks publications, BoP*

- **NPLs continue to decline, despite the fact that debt moratoria have already expired.** The NPL ratio declined by 2 tenth to 3.4% in Q2 2022.
- **Profitability is improving on a moderate basis**, exceeding levels recorded in the pre-pandemic period (ROE stood at 8.4% in Q1 2022 and 5.4% in Q4 2021 at the consolidated level). In addition, the expected path for interest rates represent 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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