Portugal: Rising yields are not good news, but not yet worrying

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DESPITE A HEIGHTENED RISK PERCEPTION, PORTUGAL IS STILL ON A POSITIVE PATH

The recent rise in debt yields in the secondary market is due both to external and internal factors, with the former being associated with a higher probability of QE tapering, while the latter has to do with a higher perception of Portuguese risk. The country would indeed suffer more than others without public debt purchases.

However, we feel that fundamentals still allow for a broadly positive view of the Portuguese path. Due to a consistent effort of budget deficit reduction, the country now enjoys a primary budget surplus large enough to ensure debt reduction, compensating for the high debt interest rates, and it would still be able to do so even if yields went up to a value like 5.5%, if primary surpluses are maintained.

The banking sector, while still under fire, is gradually sorting out its difficulties, and it is possible that no more public money will be needed.

Economic growth will still be the Achilles heel of the Portuguese situation, as high indebtedness will prevent a faster expansion, but the current dynamic should ensure a robust evolution, with an acceleration in 2017. We expect nominal growth higher than 3% in the next couple of years.

In the short term, economic performance can even bring a surprise on the upside, on account of a good dynamic towards year-end and mostly due to a weak comparison point when evaluating the first half of 2017. The solving of banking problems could also bring a positive mood, while ratings agencies (such as DBRS) will probably be a synonym more of speculation than of actual changes in outlook or rating.

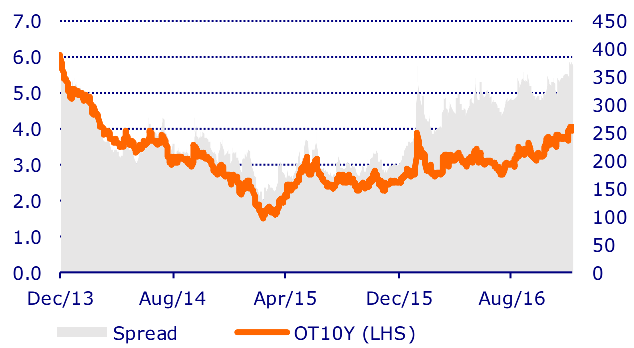
1. Debt yield rise mainly due to QE ending fears, but entails larger perception of risk...

▫ **The latest syndicated long-term issue (on January 11th) confirmed the trend of rising yields for the Portuguese debt, broadly seen their minimum around 1.6% in March 2015.** The issue saw an agreed interest rate of 4.227% for EUR 3 billion in 10-year bonds, a significant increase in comparison with the 2.973% achieved in a similarly 10-year debt syndicated issue in January 2016.

▫ **A large part of the movement in the last months was due to external factors, as the benchmark (the Bund) saw higher yields, with better expectations towards European economic performance anticipating a future end to monetary stimulus.** Looking at the 10-year yield of German bonds, there has been an increase of more than 40 basis points (b.p.) since its minimum of -0.18% in July.

OT 10 year yield and spread vs 10 year Bund

(%, basis points)



Source: Reuters, BPI calc.

▫ **However, there has been at the same time a heightened perception of Portuguese risk, implied in the larger spreads.** Following the State Budget approval in 2016, the spread dropped well below 300 points, increasing afterwards and hovering around that same threshold during the most part of the year. In the last months, it rose significantly, now standing around 370 b.p..

▫ **Indeed, the end or tapering of ECB public debt purchases would likely bring Portuguese yields up.** In December 2015, the Bank of Portugal estimated that without the ECB programme, Portuguese yields would be 2.7 percentage points higher than the level at that time, around 2.5%.

▫ **Thus, there is some reason to worry, as inflation rises in Europe and there are already repeated pressures to cut short the programme, in particular by countries like Germany.**

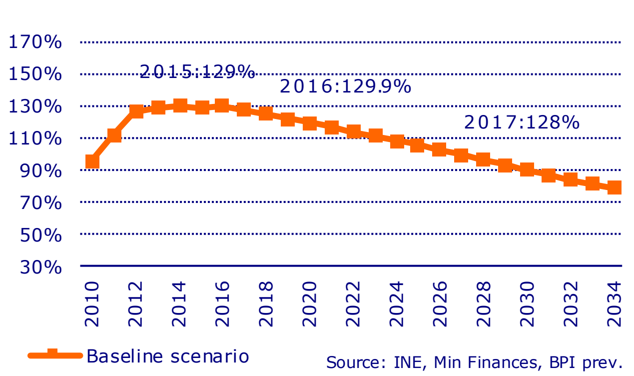
2. ...but factors like debt dynamics are relatively positive

▫ **Debt dynamics are relatively positive as absolute debt is expected to grow at a slower pace than the GDP from 2017 on.** The final figure for Debt/GDP ratio for 2016 should stay close to previous year levels' around 129%. It can even slightly decrease depending on the Executive's management of its cash buffer (the Maastricth public debt ratio is not net of Government deposits). Furthermore, it is worth to recall that last year's debt ratio was upwardly pressured by the financing of Caixa Geral de Depósitos' capital raise (EUR 2.7 bln) (already funded, according to IGCP), operation that has been postponed to the beginning of 2017.

▫ **The budget deficit is on track to be well below 3%, most likely slightly below 2.5% (the threshold imposed by the European authorities).** With some help from an extraordinary tax debt repayment scheme worth 0.3% of the GDP in revenue, the Government definitely ensured the keeping of the agreed deficit goal. **It is worth noticing the consistent path of deficit reduction since 2011, which has been yielding primary surpluses since 2013 (excluding bank operations with BES/Novo Banco and Banif).** Despite some issues with the sustainability of some strategies used (particularly in 2016), in investment cuts and Government consumption squeezes (which are compensating for other more benevolent measures, like ending public wage cuts), so far the budget credibility of the country has not been tarnished.

Public debt sustainability scenario

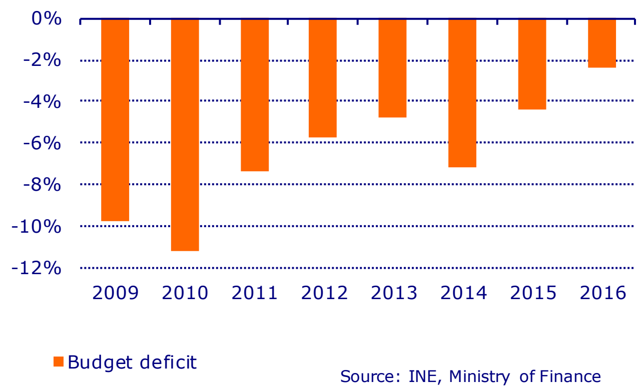
(% of GDP)



Source: INE, Min Finances, BPI prev.

Budget deficit

(% of GDP)



Source: INE, Ministry of Finance

3. Higher debt interest is a problem, yet still well under control

▫ **Interest rates paid on sovereign debt now account for about 4.6% of the GDP, which means that rising debt yields are not an issue to be ignored.** Indeed, it is likely that this percentage keeps on growing at least until 2018, where we expect it to peak at 4.8%.

▫ **However, it is relevant to point out that the average interest rate paid by the Portuguese State is well-anchored below 4%.** According to the State Budget for 2017, this value was 3.6% in 2016, largely due to the official creditors, which, through the Economic and Financial Assistance Programme, held in November 2016 about 29% of the Portuguese outstanding debt (to which the ECB's SMP debt should be added). **Even assuming a cost of 5.5% in future debt issued (annual average), it would take until 2019 for the average interest rate paid to reach above 4%, and assuming a primary budget surplus around 2% this would still lead to a (very) gradual reduction of public debt in percentage of the GDP.** What is more, even if yields remain high for a long (but finite) period of time, the Portuguese State has a substantial amount of deposits, which should be slightly above EUR 9 billion in the end of 2016, approximately 5% of the GDP (not accounting for deposits out of the Central Administration), allowing for leeway in dealing with the markets. **Still, if the increasing trend remains, it could lead to a phenomenon where a more negative perception, together with possible downgrades by ratings agencies, would result in more prohibitive interest rates.**

4. The banking sector remains a problem, but debt might not be too affected

▫ **Caixa Geral de Depósitos' capital raise is under way, and while that will entail further State funds, those are already expected.** The operation will be completed this year with EUR 2.7 billion in public money, plus EUR 1 billion in subordinated debt by private entities. Despite the fact that the success of the private debt placement is not fully assured, if all goes as according to plan, this will be a major stabilizing factor for the

Portuguese banking system, in ensuring that no further State money is needed in the next few years, as the restructuring plan seems indeed credible.

▫ **On the other hand, there is the Novo Banco sale, where various proposals are still getting looked at.** Here, the possible losses (due to the EUR 3.9 public loan to the bank-owned Resolution Fund) have already been accounted for as public debt, and, barring State guarantees to the new owner in the case of future legal/financial liabilities (something the Government is trying to avoid), any funds coming from the sale will be a positive for public debt, while the remainder of the original loan will likely be paid in a long time period by the Fund, i.e., the banks.

4. The key factor, as always, is economic growth, and it will accelerate in 2017

▫ **It is likely that the Portuguese GDP keeps a trend of moderate growth, with a medium-term expectation of 1.5-2%.** This, together with inflation around 2%, will mean nominal growth of 3.5-4%. Higher growth rates would bring much more stability for Portugal's outlook, yet it is hard to imagine such a scenario with the still very large indebtedness ratios of companies and households.

Portugal - BPI predictions			
	2016	2017	2018
Private consumption	2.0	1.4	1.4
Public consumption	0.5	0.1	0.5
Investment	-2.7	0.8	3.3
Exports	4.0	3.5	2.5
Imports	3.1	2.3	2.5
GDP	1.3	1.5	1.5
Budget deficit	2.7	2.5	2.5
Average inflation	0.6	1.2	1.5
Average unemployment rate	11.4	11.0	10.7

▫ **This is the largest problem with the Portuguese debt situation, because such growth rates will demand permanent and significant (around 1.5-2%) primary surpluses, in order to ensure debt reduction.** And while this is certainly possible, it is likely that it might not be politically sustainable. In this sense, the next few years will be key to see if the budget-reducing strategy is effective or not, or whether some of the public spending is only contained temporarily. In particular, it will be hard to maintain such low levels of public investment (although final data are not yet available, sources have put the 2016 level at 1.8% of the GDP, the lowest recorded level).

5. In the short term, despite yield volatility on QE speculation, the outlook is calm

▫ **While we do not expect major positive surprises, it is likely that economic growth should be robust in the end of 2016 and particularly the first quarters of 2017, as the comparable base is weak (due to temporary factors, likely to improve, such as Angola's situation).** Other than that, the remaining banking problems to be solved are probably the most major events to happen in the near future, which, if well managed, could bring a positive factor in terms of stability to the Portuguese economy. Finally, various ratings agencies are expected to review Portugal's sovereign rating, and while the opinions of the "big three" are relevant, these should not be too significant, as they are not likely to change their evaluation. DBRS's take is more important at this time, as it allows for Portugal's public debt to be purchased by the ECB's QE programme, but we also do not think it likely that the Canadian agency should downgrade the Portuguese rating. Nevertheless, volatility with Portuguese debt could be expected around April 21st.

Relevant events	
Date	**Event**
January 13	Moody's rating review
February 3	Fitch rating review
February 8	Employment Statistics Q4 2016
February 14	2016 Q4 GDP 1st estimate
March 1	2016 Q4 GDP 2nd estimate
March 17	S&P rating review
April 21	DBRS rating review

Sources: Moody's, Standard & Poors, Fitch, DBRS, INE

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