Portugal:
Macroeconomic and financial outlook

BPI *Research*

January 2023

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BPI Grupo CaixaBank

Main messages

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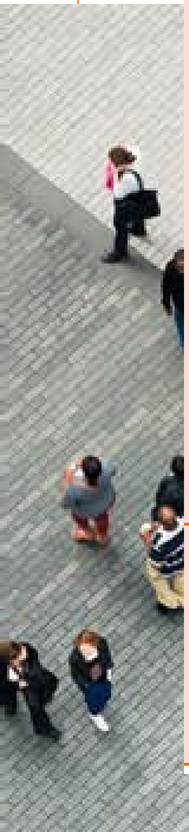


Activity

- **Annual GDP growth in 2022 revised to 6,7% from 6,3%.** Last data suggest that a contraction in Q4 may be avoided, which together with a better than expected performance in Q3 led us to revise upwards annual growth in 2022. 2023 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: 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. For now we predict a 0,5% annual growth in 2023, with risks biased favourably.
- **Annual Inflation jumped to 7,8% in 2022. Going forward inflation is expected to decelerate gradually,** reflecting the contagion to other goods of energy prices in higher levels. This is apparent in the fact that core inflation continues to accelerate while global inflation is already showing first signs of decline.
- **High frequency indicators related to the tourism sector confirm strong recovery.** The number of flights in Q4 already surpassed those of 2019, suggesting that the sector continues to expand and support growth.
- **Housing prices accelerated further in Q3 (2,9% qoq and 13,1% yoy), consolidating expectations of an annual rise in 2022 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 and a smaller number of transactions.
- **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 of 0,9% of GDP in the first 11 months of 2022, which compares to -3,3% and +0,3% in the same period of 2021 and 2019, respectively.
- **State Budget for 2023 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 this figure will probably be better than expected) and the public debt ratio should decline to 110,5% of GDP from 115% 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 public administration liquidity cushion (which includes the Treasury cash buffer) amounts to circa €19 bln (≈8% of GDP), still higher than end of 2019 levels (€14 bln).

Banking Sector

- **Credit quality indicators improved further in Q3 2022 and we evaluate risks related with higher interest rates as contained.** Indeed**,** macroprudential measures are relatively tight. Recently, additional measures were taken in order to reduce the maturity of housing loans; also, before granting a loan, banks have 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

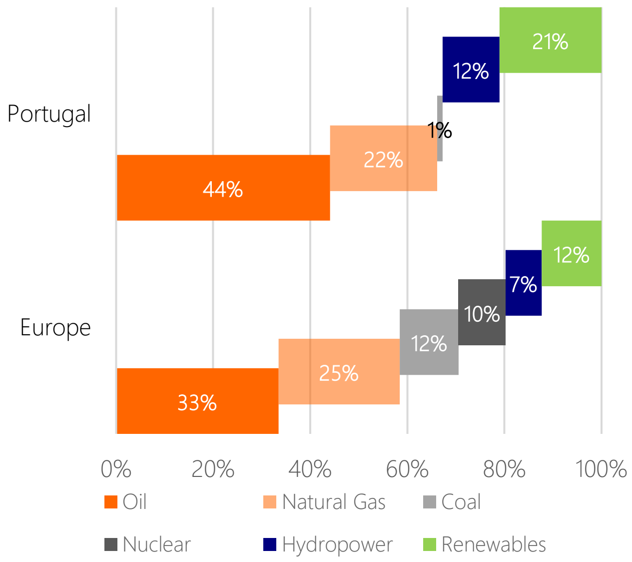
%, yoy	2014	2015	2016	2017	2018	2019	2020	2021	Forecasts 2022	Forecasts 2023
GDP	0,8	1,8	2,0	3,5	2,8	2,7	-8,3	5,5	6,7	1,0
Private Consumption	2,5	1,9	2,6	2,1	2,6	3,4	-6,9	4,7	5,9	0,9
Public Consumption	-0,5	0,8	0,8	0,2	0,6	2,1	0,4	4,6	2,1	1,0
Gross Fixed Capital Formation (GFCF)	2,3	5,9	2,5	11,5	6,2	5,4	-2,2	8,7	1,3	2,5
Exports	4,3	6,2	4,4	8,4	4,1	4,1	-18,8	13,5	17,1	4,3
Imports	8,1	8,1	5,0	8,1	5,0	4,9	-11,8	13,3	10,8	4,5
Unemployment rate	14,5	13,0	11,4	9,2	7,2	6,6	7,0	6,6	6,0	6,4
CPI (average)	-0,3	0,5	0,6	1,4	1,0	0,3	0,0	1,3	7,8	5,5
External current account balance (% GDP)	0,2	0,2	1,2	1,3	0,6	0,4	-1,2	-1,1	-1,5	-1,0
General Government Balance (% GDP)	-7,4	-4,4	-1,9	-3,0	-0,3	0,1	-5,8	-2,9	-1,1	-0,9
General government debt (% GDP)	132,9	131,2	131,5	126,1	121,5	116,6	134,9	125,5	114,3	109,7
Risk premium (PT-Bund) (average)	215	188	346	149	147	67	59	65	135	115

Source: *BPI Research*

Energy mix with more renewables provides a buffer against volatile environment

Primary energy source

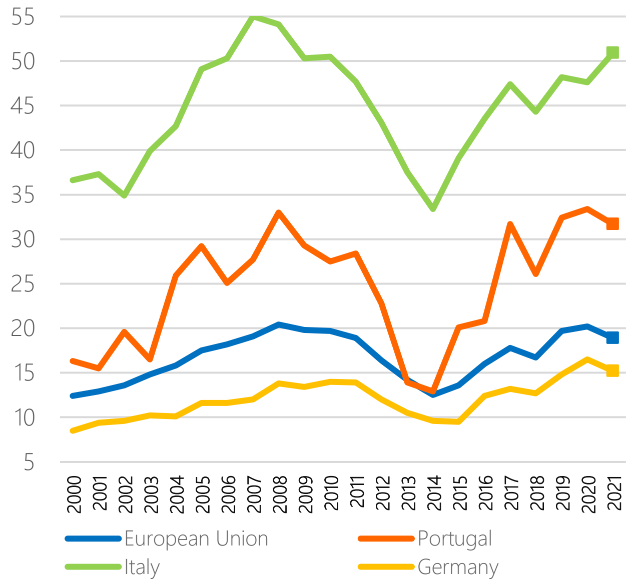
%



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

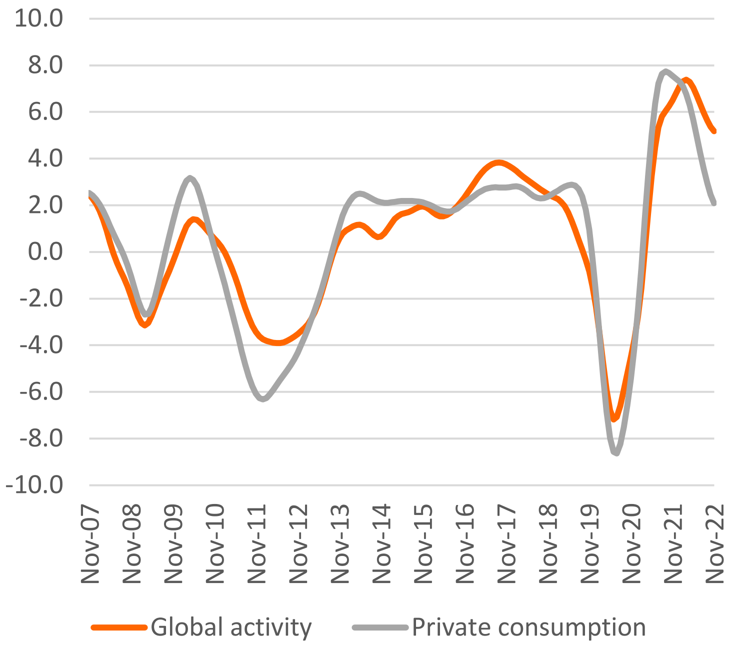
Eur/MWh

Source: BPI Research, using data from Bloomberg.

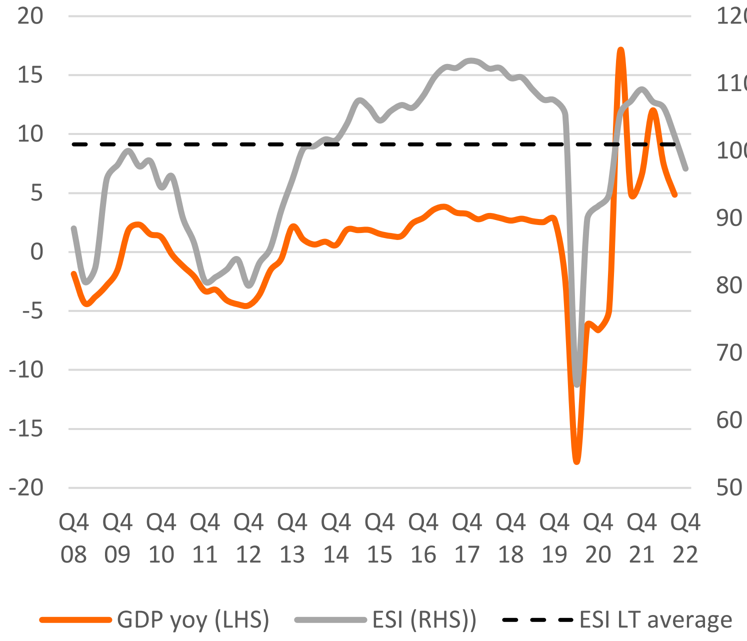
- **Compared to the rest of Europe, Portugal is more dependent on oil as a primary energy source (44%).** On the other hand, the energy component via renewable energies is also substantially higher.
- **In 2021, natural gas was the source of 31,7% of the electricity produced**, meaning that the country 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 70 eur/MWh) due to the warm winter so far, energy saving measures at EU level and coordinated policy and diversification of providers.
- 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.

The pace of expansion kept slowing at the turn of the year...

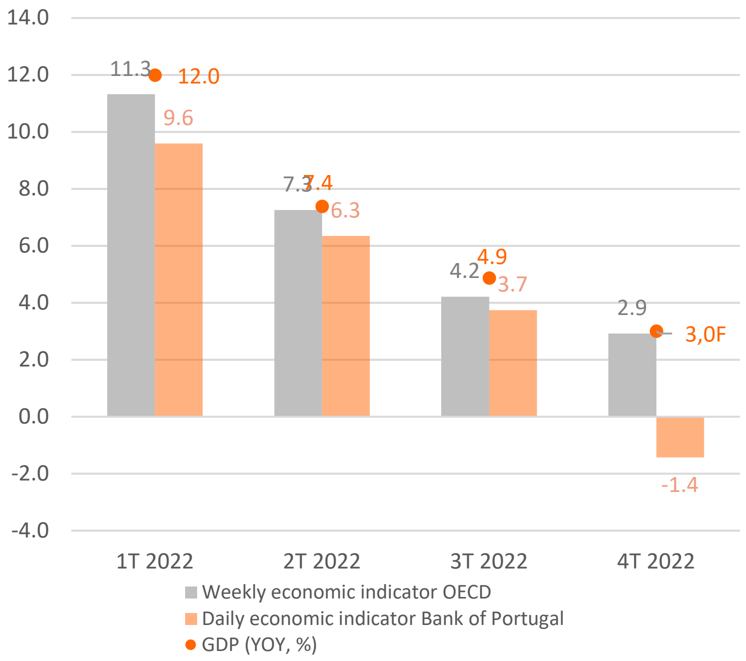
Coincident indicators
%



GDP & EC Sentiment indicator
Yoy, level



High frequency indicators
Yoy %



***Source**: BPI Research, from INE, BoP, EC and OECD*

- **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 the economy.
- The Economic sentiment indicator calculated by the European Commission continues to decline, ending 2022 at 96,7 points, below the long term average of 100, an additional signal of weakness ahead.

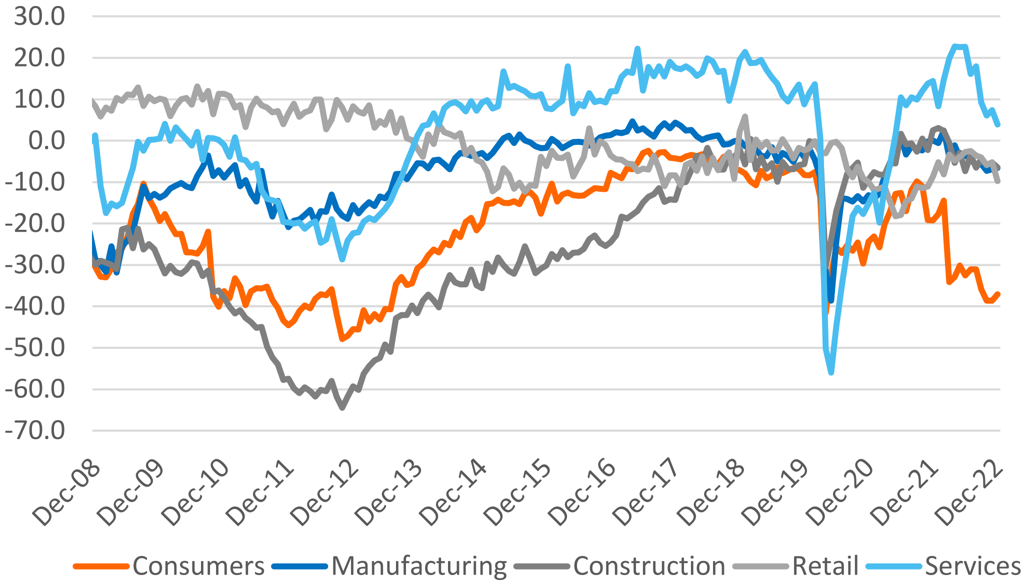
… but it is plausible that a contraction will be avoided

Economic indicators *% mom, qoq*	Q4 2022	Q3 2022	Last month
Employment (change 1000 individuals)	-14,2	14,6	November
Unemployment (change 1000 individuals)	7,6	-16,2	November
Retail sales (deflated)	1,7	0,4	November
Car sales *(ACAP)*	5,4	-0,9	Q4 2022
Exports of goods *(yoy)*	24,5	27,9	November
Overnight stays *(yoy same month 2019)*	-1,0	2,5	November
ESI *(historical average ~100)*	97,4	102,2	Q4 2022

Source: BPI Research, from BdP, INE, EC

Confidence indicators

Level



- **Consumption is being supported by an increase of durable goods consumption, namely cars.**
- **Labour market remains strong, but first signs of weakness are appearing:** most recent data shows a decline in employment in chain, but on a yoy basis, both employment and unemployment are still improving.
- **Accumulated savings during pandemic,** (~3% of GDP) will continue to partially accommodate at least some of the adverse impact of higher inflation and higher interest rates in the coming quarters. But, 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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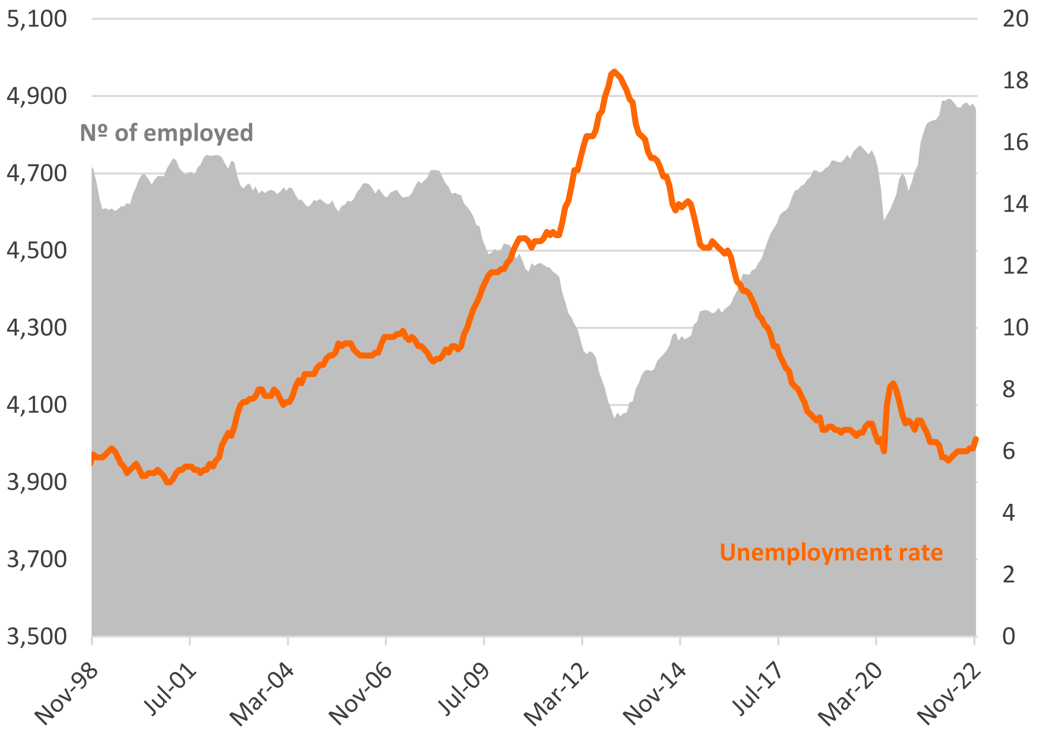
Employed population and unemployment rate

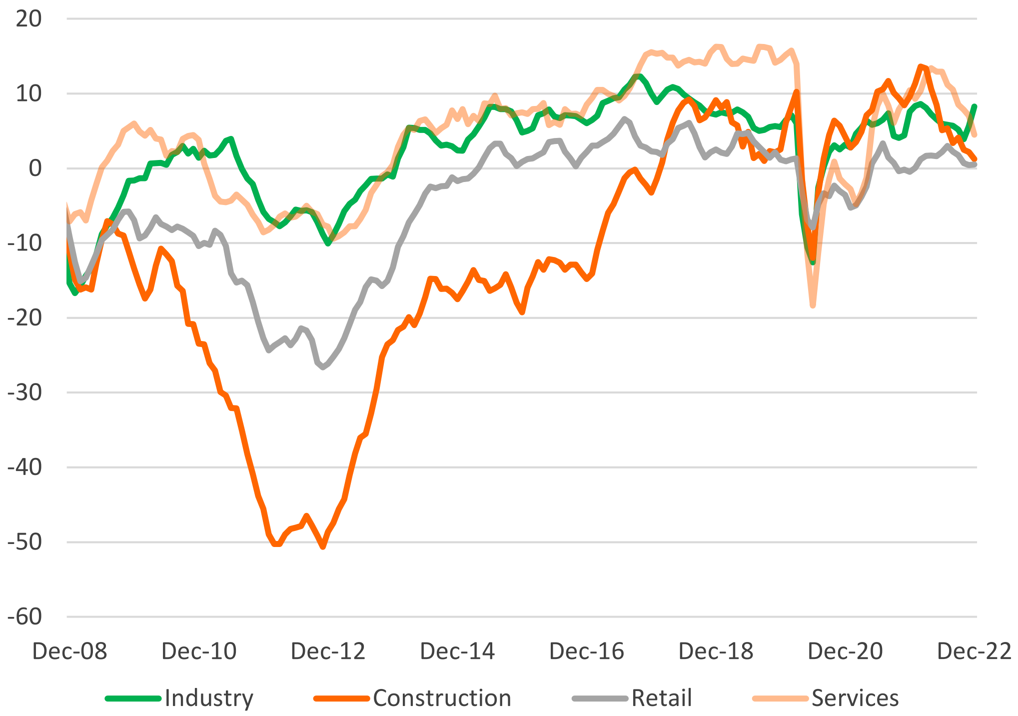
Thousand people *(%)*



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 increased again in November and the unemployment rate rose to 6.4% (6,0% in October); employment perspectives for the next 3 months by sector are decreasing, except in industry.
- **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: climbed to 7,8% in 2022, but there are signs of a small deceleration

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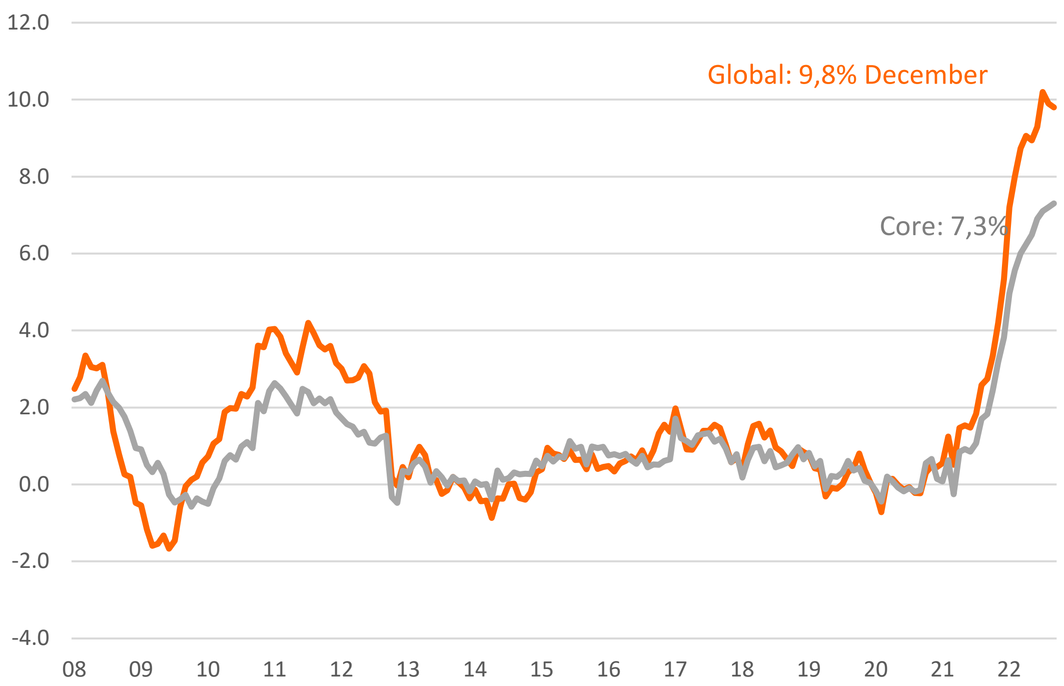
The global and core inflation

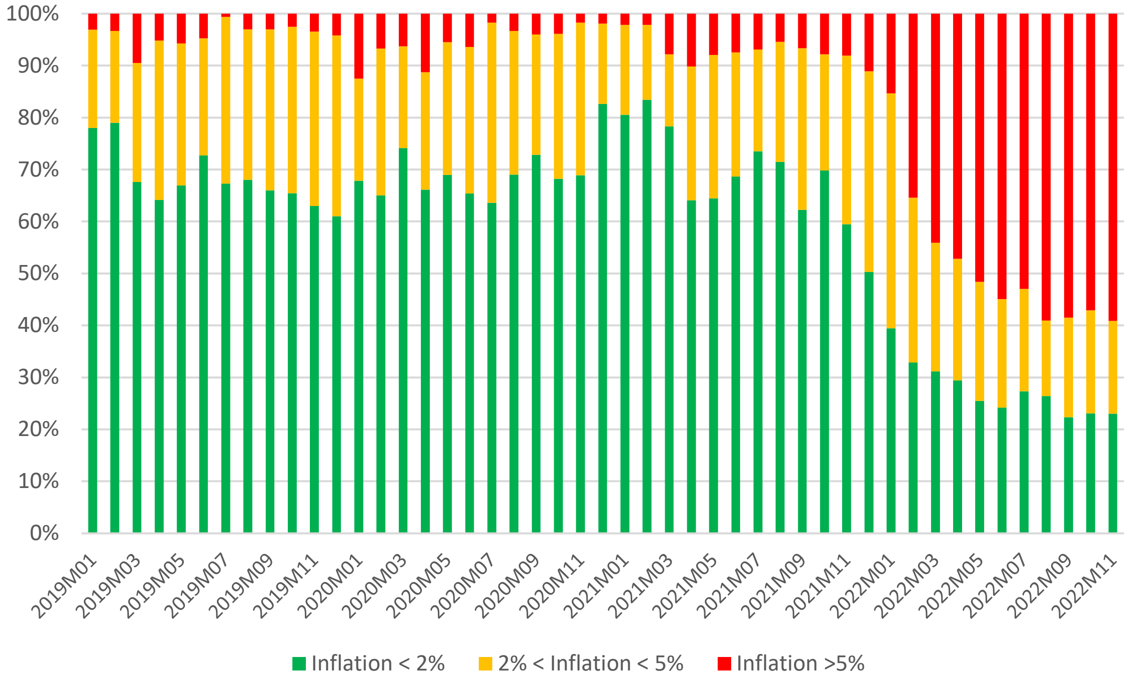
Year-on-year (%)



Source: BPI *Research, from INE*

The inflation traffic light

% of CPI basket



- **Inflation decelerated** to 9,8% in December from 9,9% in November; energy prices decelerated, but higher energy prices continue to spread to other prices and core inflation accelerated to 7,3%, from 7,2%.
- **Average inflation in 2022 was 7,8% and is expected to stay higher for longer. For 2023 we are predicting 5,7%.** The accumulation of global shocks and spillover effects from energy and food prices to most components of the basket are the main issues behind higher levels of inflation during more time.

GDP: after a strong 2022, 2023 will be a more difficult year

Bank of Portugal December economic scenario vs BPI scenario

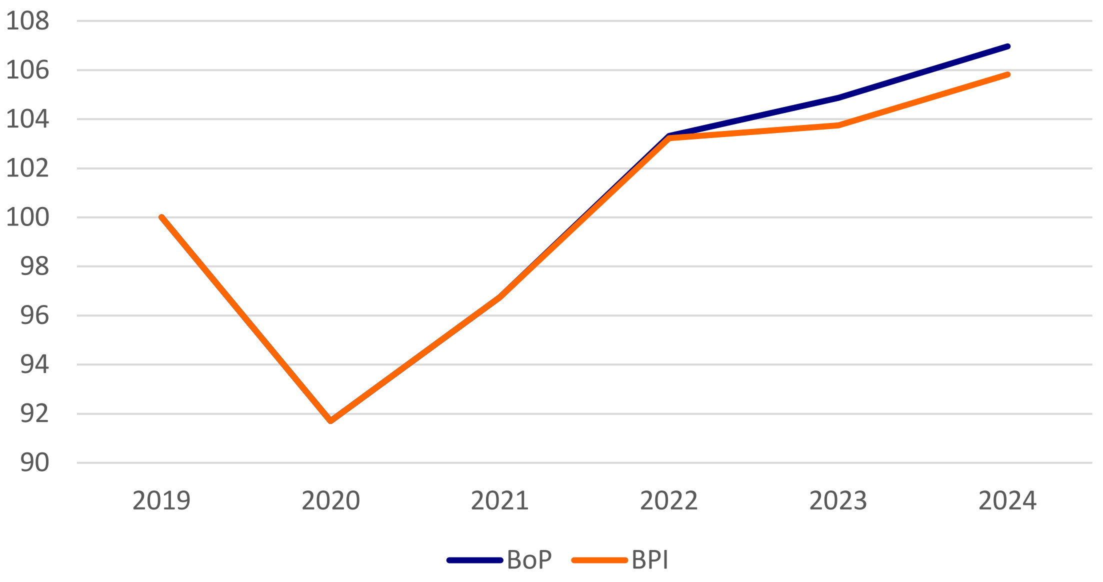
%

Portugal		2021	2022	2023	2024	Accum. 22-24
GDP	BoP Dec-22	5.5	6.8	1.5	2.0	10.6
(annual, %)	*BoP Dec-22 (adverse)*		*6.8*	*-0.4*	*0.3*	*6.7*
	BPI Dec-22		***6.7***	***0.5***	***2.0***	***9.4***
Unemployment rate	BoP Dec-22	6.6	5.9	5.9	5.9	-0.7
(annual average, %)	*BoP Dec-22 (adverse)*		*5.9*	*7.1*	*7.9*	*1.3*
	BPI Dec-22		***5.9***	***6.4***	***6.1***	***-0.5***
Inflation rate[1]	BoP Dec-22	1.3	8.1	5.8	3.3	18.1
(annual average, %)	*BoP Dec-22 (adverse)*			*8.0*	*5.1*	*22.7*
	BPI Dec-22		***7.8***	***5.7***	***2.2***	***16.6***

BoP forecasts are for the HCPI; BPI forecasts for the CPI; for unemployment, the cumulative 22-24 is computed as the difference between unemployment in 2024 vs unemployment in 2021

GDP Growth

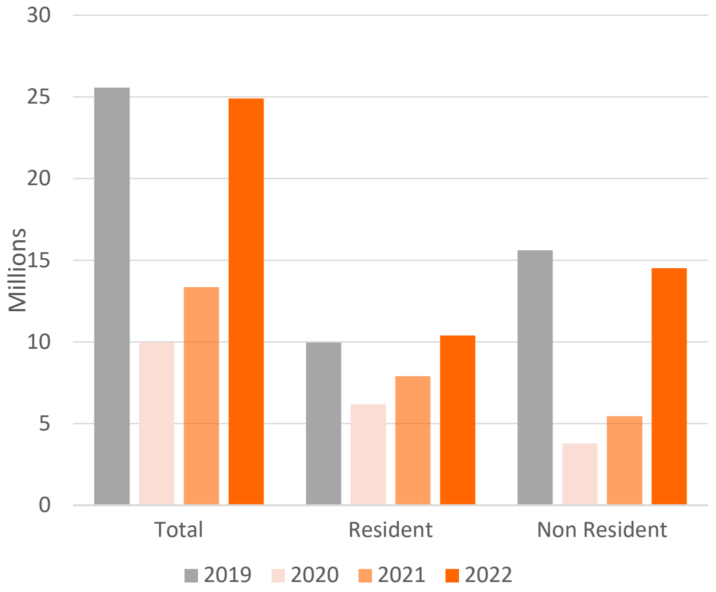
Level, 2019=100



- **BPI's forecast is more conservative for growth in 2023 (+0,5%); however, in early January, economic data suggests that deceleration may be more moderate than predicted in our scenario. If this evolution is sustained, an upward revision of growth in 2023 looks probable.**
- **The Bank of Portugal scenario:**
  - GDP will advance 1,5% in 2023 (-1,1 percentage point than forecasted in June). High level of global uncertainty, loss of purchasing power, higher financing costs and weaker external demand are the factors behind the strong deceleration estimated for 2023, affecting mainly private consumption.
  - Inflation will stay higher for longer; return to 2% postponed to 2025. The accumulation of global shocks and spillover effects from energy and food prices to most components of the basket will translate to higher levels of inflation during more time.
  - Unemployment rate is predicted to remain stable, despite the strong deceleration of growth, reflecting difficulties in hiring.
  - **Uncertainty is very high and risks are negatively biased for growth and upward biased for prices.** Materialization of risks (adverse scenario) – total cut in gas and oil supplies from Russia to Europe, slower substitution by other energy sources, and a colder than usual winter – may led to the contraction of growth in 2023 and to higher levels of inflation.

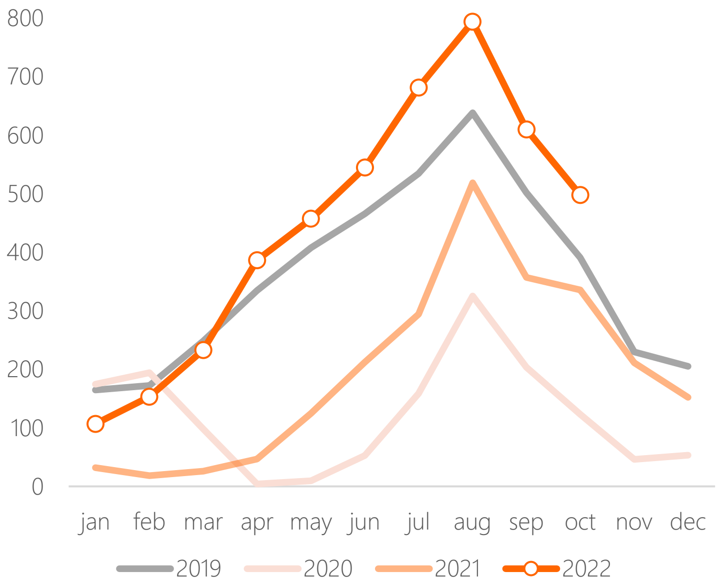
Tourism heading to pre-pandemic standards

Number of guests
Accumulated up to November



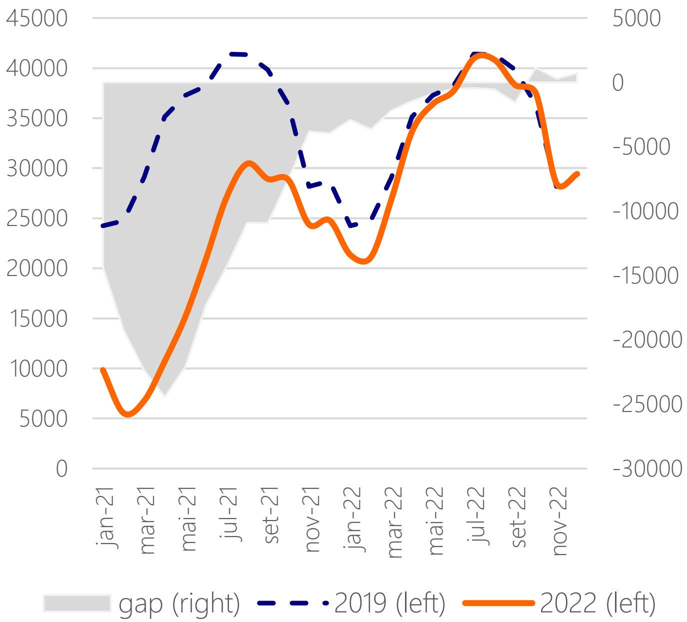
Source: BPI Research, using data from INE.

Revenue at tourist accommodation establishments
Million euros



Source: BPI Research, using data from INE.

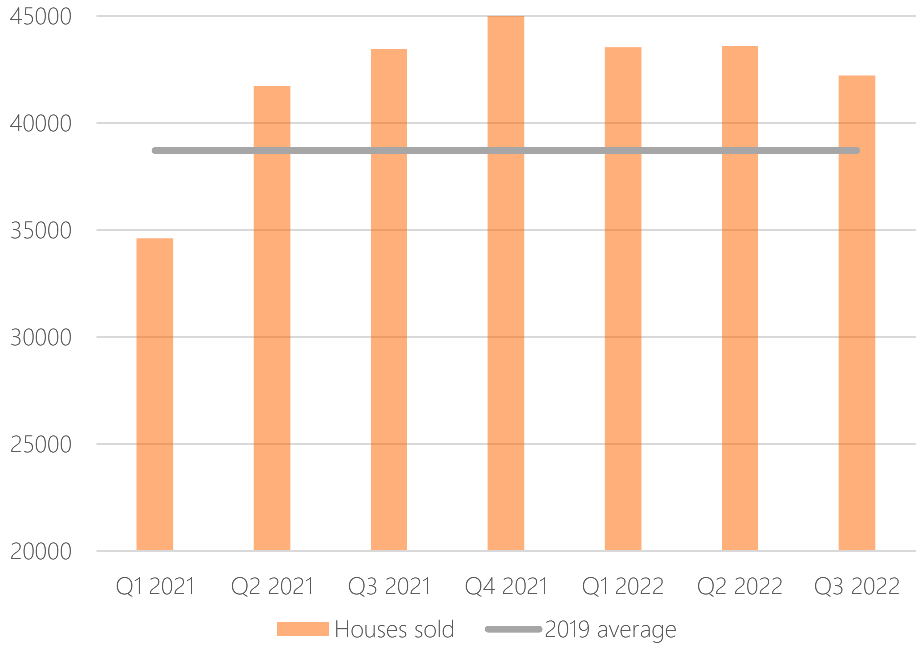
Portugal: monthly flights
Accumulated up to December



- **Up to November, the overall number of guests reached 24,9 million, minus 2,6% than in the same period of 2019.** Non-residents are still 7% below the 2019 level, but residents already exceed the 2019 level by 54%.
- With this performance, we expect the number of tourists visiting Portugal by the end of 2022 to be around 96% of the pre-pandemic level and this to be slightly exceeded next year.
- **Up to November, the revenues at tourist accommodation establishments surpass the same period of 2019 by 27%.**
- **The number of airline tickets issued to Portugal in recent months has been higher than in 2022**, 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.

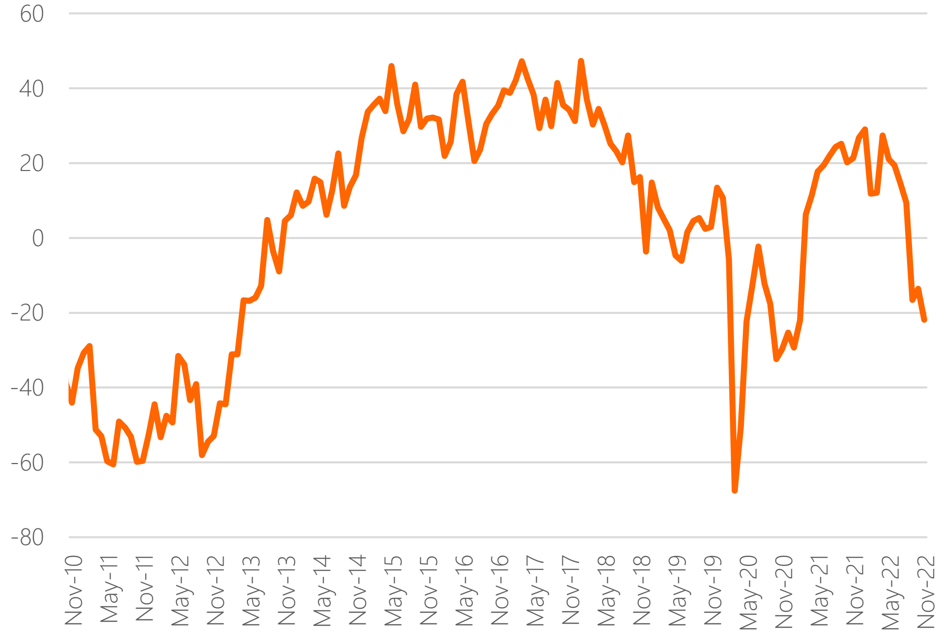
Housing market: strong in 2022 but some signs of market slowdown

Houses sold
Number



Source: BPI Research, using data from Confidencial Imobiliário.

Economic sentiment in real estate
Level



- **In 2022 we expect an average housing valuation of 11.7%:** recent data from Confidencial Imobiliário continues to show strong appreciation of residential property, but in deceleration. In November it grew 18,8% yoy (+19,4%yoy in October). 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.
- **Interest rate hike cycle is being stronger than expected and that is probably impacting confidence indices in the real estate sector.** Tighter financial conditions should be reflected in demand, especially in 2023. In this sense we expect the average valuation of properties to correct slightly in 2023 (-1.5%).

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

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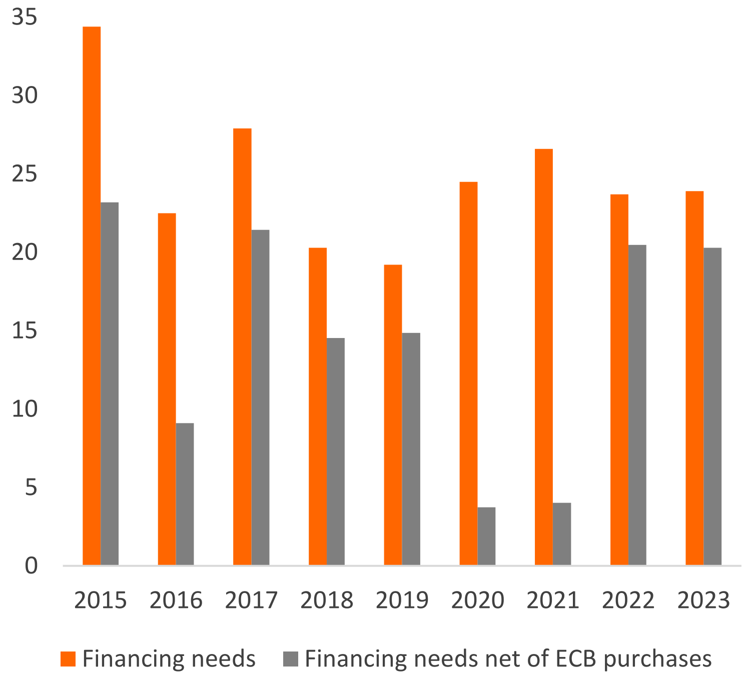
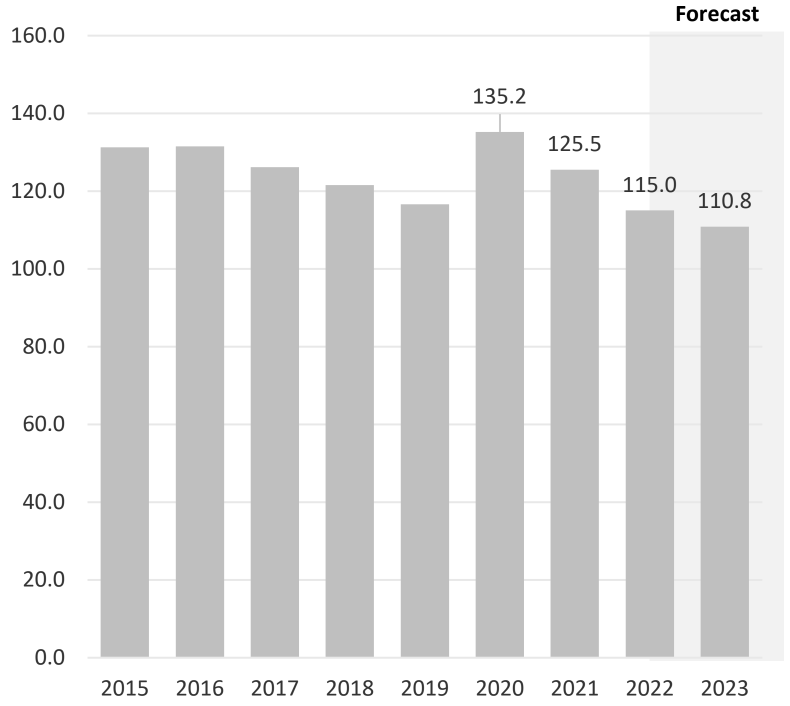
Funding needs
(Billion euros)



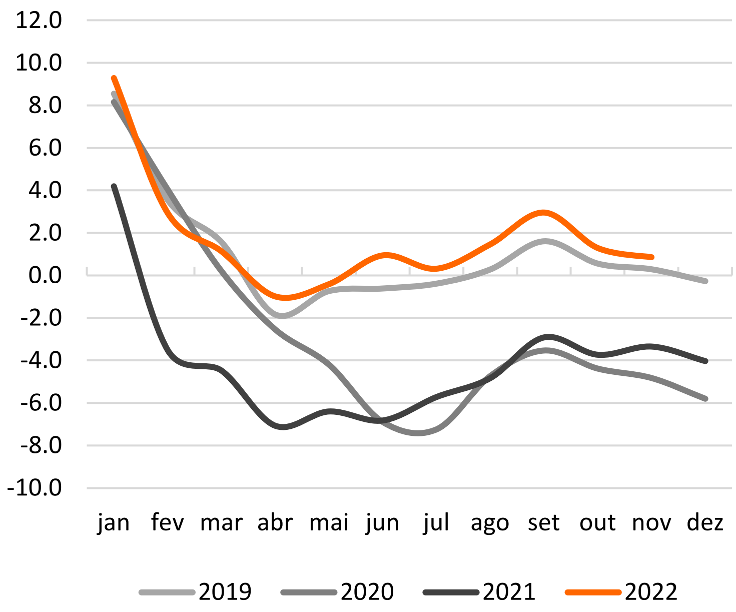
***Source**: BPI Research, based on DGO and state budget 2023.*

Public debt ratio
(% of GDP)



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

Overall fiscal balance
(% of GDP)

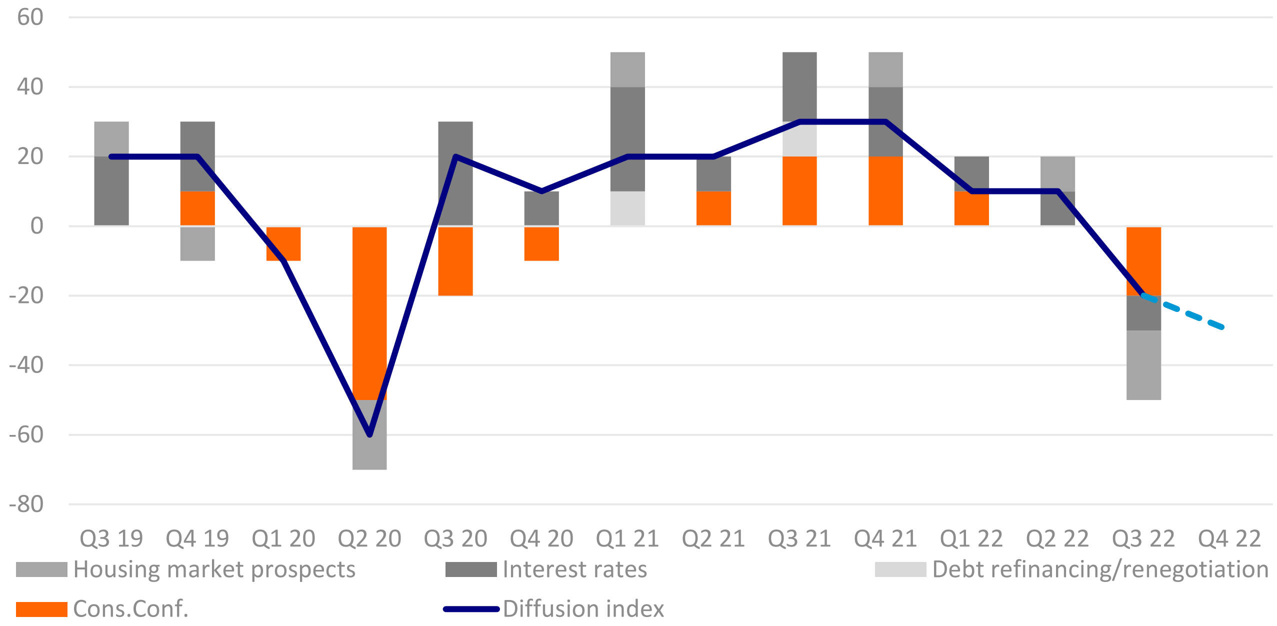


***Source**: BPI Research, from DGO data.*

- **Financing needs for 2023 amount to €24 bn. In the Q2, ECB will start the quantitative tightening through reduction of reinvestments of debt purchased under the APP;** debt that matures under the PEPP continues to be reinvested. Despite this change in the ECB's policy (a more restrictive stance), ECB is expected to purchase debt equivalent to circa 15% of financing needs in 2023, a similar amount than in 2022. The muted reaction of the sovereign spread to the reduction of ECB purchases already in 2022, demonstrate the more positive evaluation of the Portuguese sovereign risk by international investors, in part due to a very cautious fiscal stance. Still, the current liquidity cushion (public administration deposits, including the Treasury cash buffer) amounts to around €19 bn (c. 8% of GDP).
- The Portuguese Treasury is carrying out a policy of repurchase of short-term securities and has been selling bonds with longer maturities, removing pressure on public debt in the short term; last January, the Treasury issued an 15 year benchmark OT 3.50% bonds due 18 June 2038.
- 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.

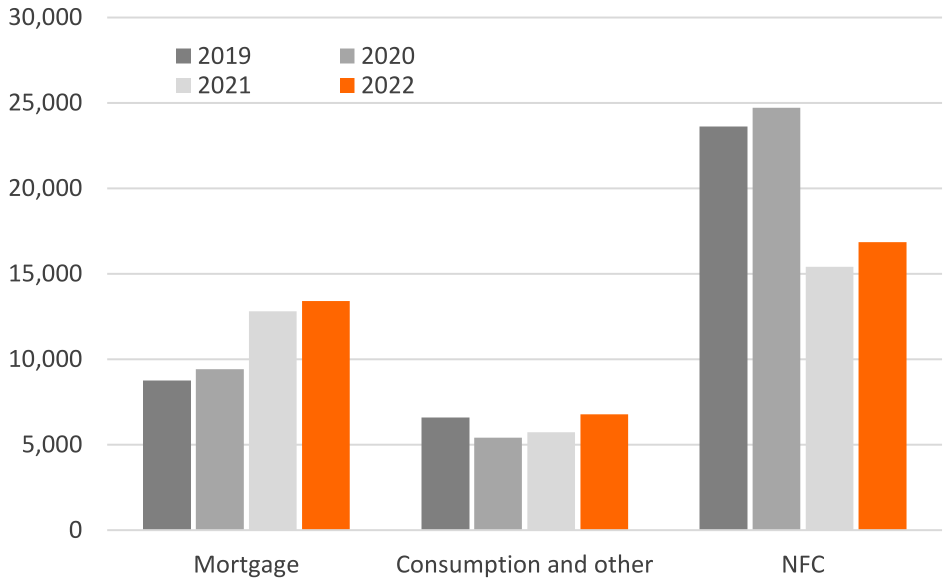
Banking system: a solid position to face the economic slowdown (1)

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 November), Bn euros

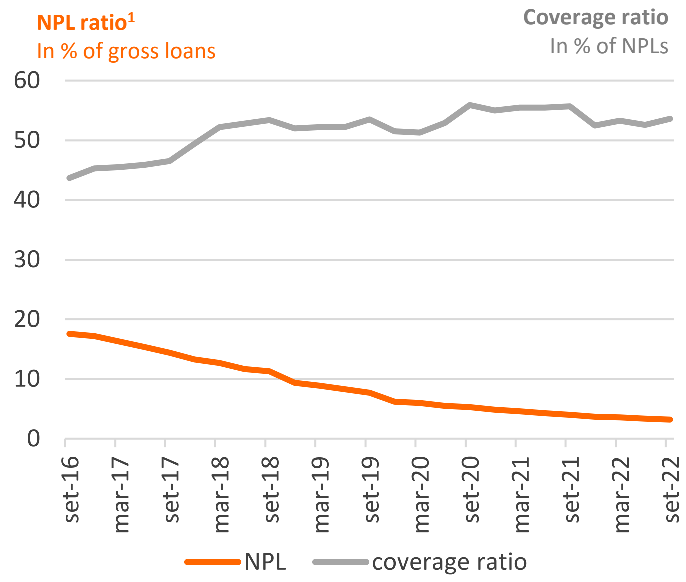


Source: CaixaBank Research, base on data from Bank of Portugal and ECB.

- **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 November 2022, new financing for NFC and households increased (9.3% and 9.0%, respectively), but is showing signs of deceleration. In fact, looking at November, new mortgage credit decreased circa 12% yoy; however, new production continues at higher levels than the average seen in 2019. For NFC, the amount also decreased in November: -4,3% yoy.
- **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 the economic slowdown (2)

NPLs and coverage ratios



Cost of risk[1]
0.5% in 2019
0.2% in Q3 2022

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

Banks' profitability

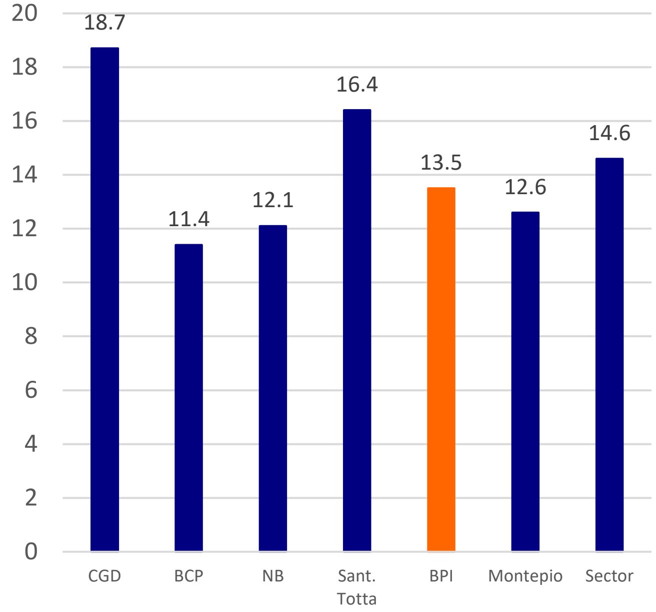
In % of average total assets (Q3 22; trailing 12M)

	BPI	BCP	San Totta	CGD	NB	Montepio
Net interest income	**1.2%**	**1.3%**	**1.2%**	**0.8%**	**1.2%**	**1.2%**
Net fees	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Gains on financial assets	0.1%	0.2%	0.1%	0.1%	0.2%	0.2%
Other net profits	-0.1%	-0.1%	-0.1%	0.0%	0.4%	-0.1%
Gross income	**1.9%**	**2.3%**	**2.0%**	**1.5%**	**2.4%**	**1.8%**
Operating expenses	-1.1%	-0.9%	-0.8%	-0.7%	-0.9%	-1.2%
Operational result	**0.8%**	**1.4%**	**1.2%**	**0.8%**	**1.5%**	**0.6%**
Impairment losses, taxes and others	-0.1%	-0.5%	0.0%	0.3%	-0.1%	-0.2%
Profit	**0.5%**	**0.6%**	**0.8%**	**0.8%**	**1.3%**	**0.2%**
ROTE[1]	10.6%	2.5%	11.1%	10.8%	nd	nd

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

Banks' solvency and liquidity position

In % (Q3 22)



Source: Banks publications, BoP
Q2 for Santander Totta and Montepio

- **NPLs continue to decline, despite the fact that debt moratoria have already expired.** The NPL ratio declined by 2 tenths to 3.2% in Q3 2022.
- **Profitability remains well above the pre-pandemic period,** but decelerated 6 tenths in Q3 (ROE fell 8.3% in Q3 2022 from 8.9% in Q2). Even so, profitability is expected to benefit from higher interest rates.
- **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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