Portugal:

Macroeconomic and financial outlook

BPI *Research*

February 2023

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BPI Grupo CaixaBank

Main messages

Activity

- **Annual GDP grew 6,7% in 2022.** Performance in Q4 was better than expected, as a contraction was avoided (+0,2% qoq and +3,1% yoy). 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. We revised upward our annual growth forecast in 2023 to 1,0% from 0,5%. Risks are balanced.
- **Annual Inflation jumped to 7,8% in 2022.** In January, inflation decelerated by 1,3 p.p. to 8,3% yoy and core inflation fell to 7% for the first time in the last 15 months, suggesting a more benign path in the rest of the year. Even so, this should be a gradual process reflecting the contagioun of high energy prices to other products. We predict that inflation may stay around 5% in 2023.
- **High frequency indicators related to the tourism sector confirm strong recovery.** Recovery from pre-pandemic levels is not still complete **-** guests are still 2.3% and overnight stays 0.9% below 2019 levels – but in 2023, these number are expected to surpass 2019 levels.
- **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 this year and a smaller number of transactions.
- **Public accounts are having a very good performance, one of the factors behind recent improvements of sovereign debt risk evaluations (rating improved by one notch, by S&P's and Fitch to BBB+, DBRS to A).** On a cash basis, public balance registered a deficit of 1,5% of GDP in 2022, which compares to -4,0% and -0,3% in 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 €14 bln (≈6% of GDP), the same amount as registered at the end of 2019 (€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.

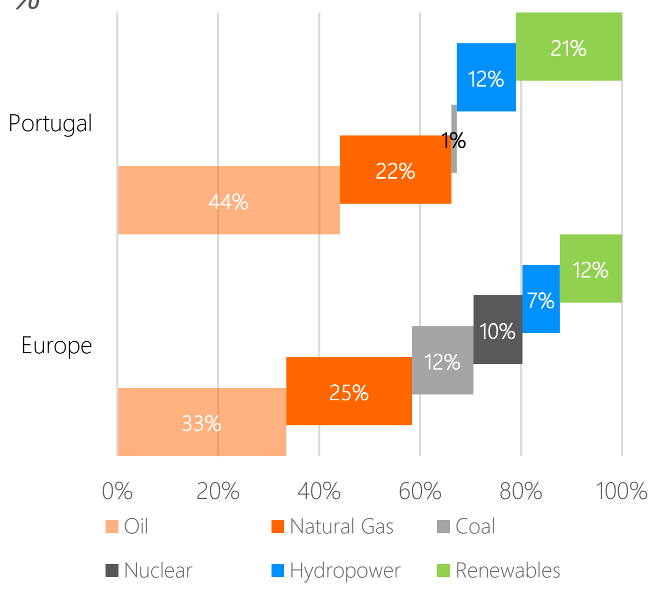
Main economic forecasts

%, 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	-1.2	-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	97	105

Source: *BPI Research*

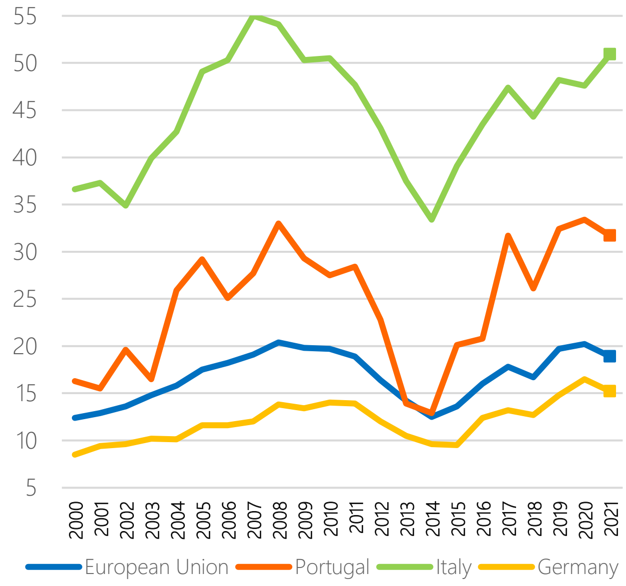
Energy mix with more renewables provides a buffer against volatile environment

Primary energy source
%



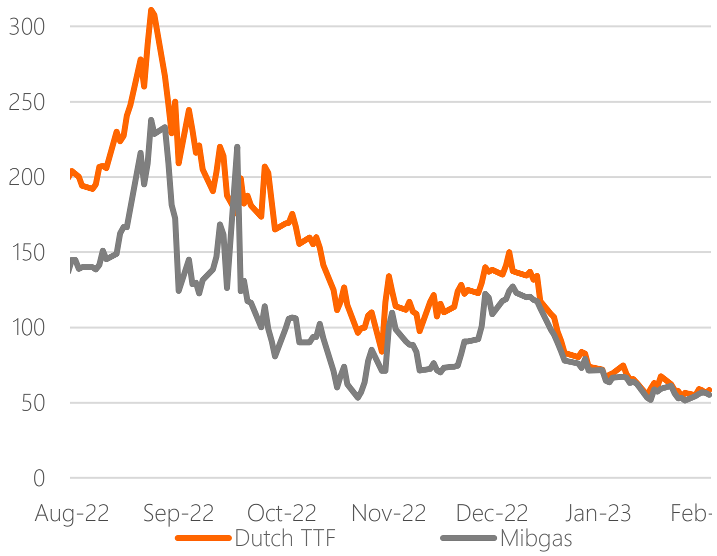
Source: BPI Research, using data from Our World in Data,

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



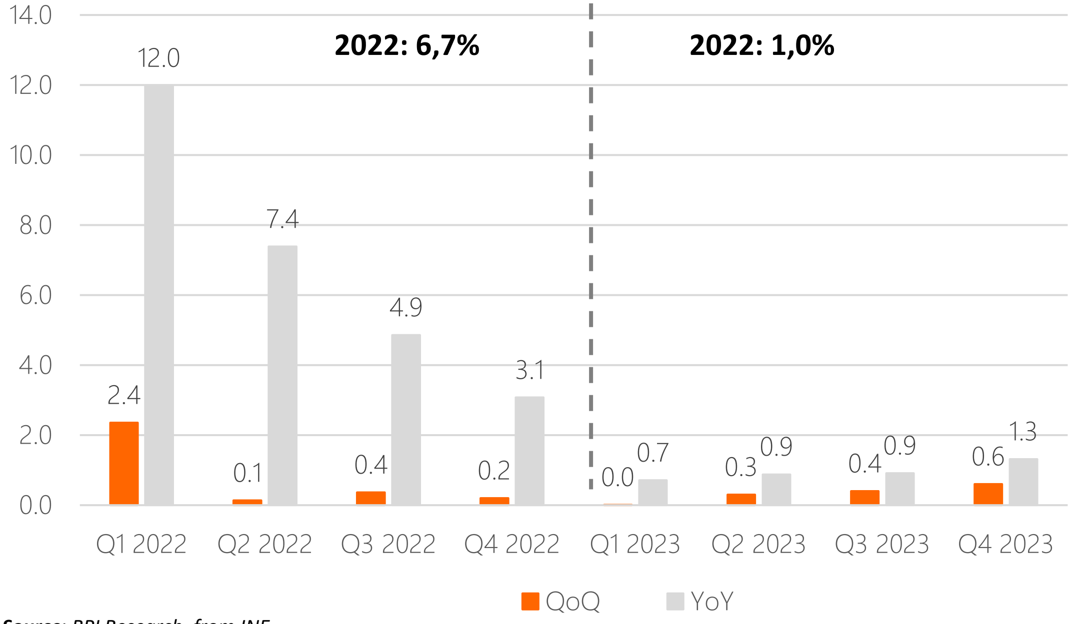
Source: BPI Research, using data from Bloomberg,

- **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.
- **The gap between the reference gas price in the European market (Dutch TTF) and the reference price in the Iberian gas market (Mibgas) is narrowing.** The difference registered during 2022 was 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 still does not have sufficient infrastructure to receive and gasify the gas it needs.

GDP: exceptional growth in 2022, but 2023 will be a more difficult year..

GDP Growth: last readings and forecasts

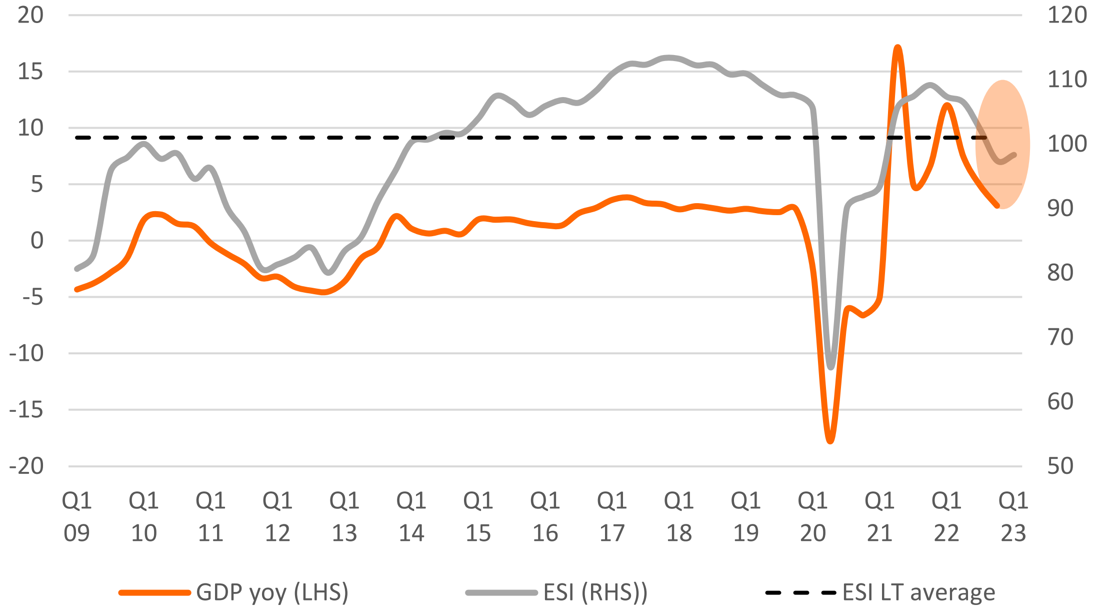
Yoy, level



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

GDP & EC Sentiment indicator

Yoy, level



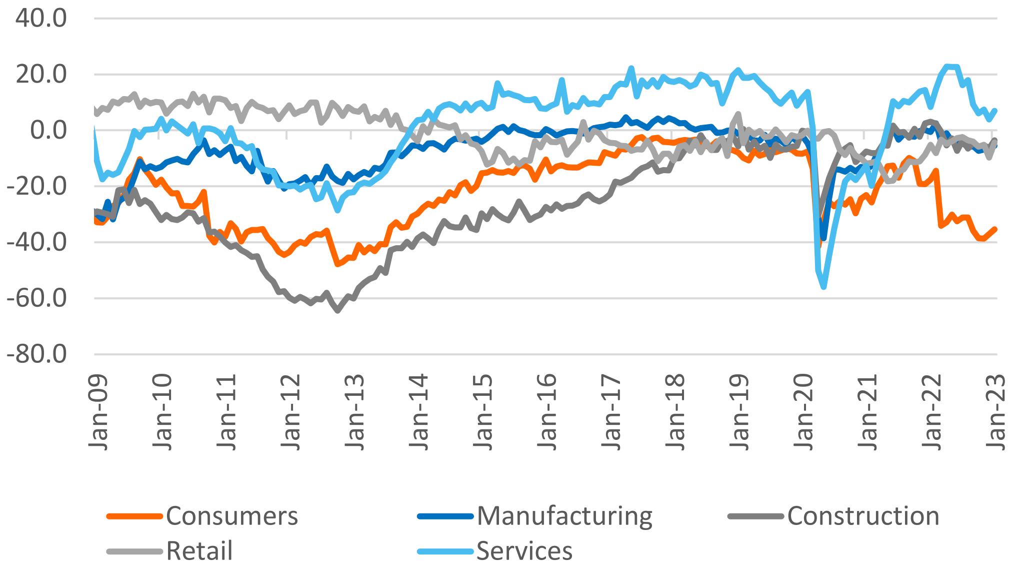
- **Strong growth in 2022**: GDP increased 6,7% in 2022, in line with our forecasts. In the last quarter, GDP advanced 0.2% qoq and 3,1% yoy, less than in the previous quarter, reflecting deceleration on consumption, investment and exports. Detail regarding GDP in Q4 will be released on February 28th, but it should confirm that in Q4, GDP stood 3,2% above Q4 2019 levels.
- **For 2023, we expect a strong deceleration of activity,** reflecting the impact of higher interest rates; inflation is expected to remain high due to contagion of higher energy prices to other goods; unemployment should rise a bit reflecting the strong deceleration of activity, as higher interest rates, the persistence of high inflation and the negative impact of the energy crises on external demand will cause significant deceleration of economic activity. On the positive side, we have families that still have some leeway related to accumulated savings and also the stimuli coming from the execution of NGEU.
- The scenario is subject to a high degree of uncertainty but, for now, risk seems balanced. The more positive behavior of energy prices, first signs of deceleration of inflation and higher resilience of European economies support our scenario.

… but it is plausible that a contraction will be avoided

Economic indicators *% mom, qoq*	Q4 2022	Q3 2022	Last month
Employment (change 1000 individuals)	-18,8	14,6	Q4 2022
Unemployment (change 1000 individuals)	15,1	-16,2	Q4 2022
Retail sales (deflated)	-0,1	0,4	Q4 2022
Car sales *(ACAP)*	5,4	-0,9	Q4 2022
Exports of goods *(yoy)*	23,3	27,9	December
Overnight stays *(yoy same month 2019)*	-0,9	2,5	2022
ESI *(historical average ~100)*	98,3	97,4 (Q4 2022)	January 2023

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 deterioration in both employment and unemployment.
- **Accumulated savings during pandemic,** (~2% 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**: in January, the sentiment improved in all sectors: industry, retail, construction, services and consumers.

Despite the challenges ahead, GDP is more than 3% above pre-Covid

Bank of Portugal December economic scenario vs BPI scenario

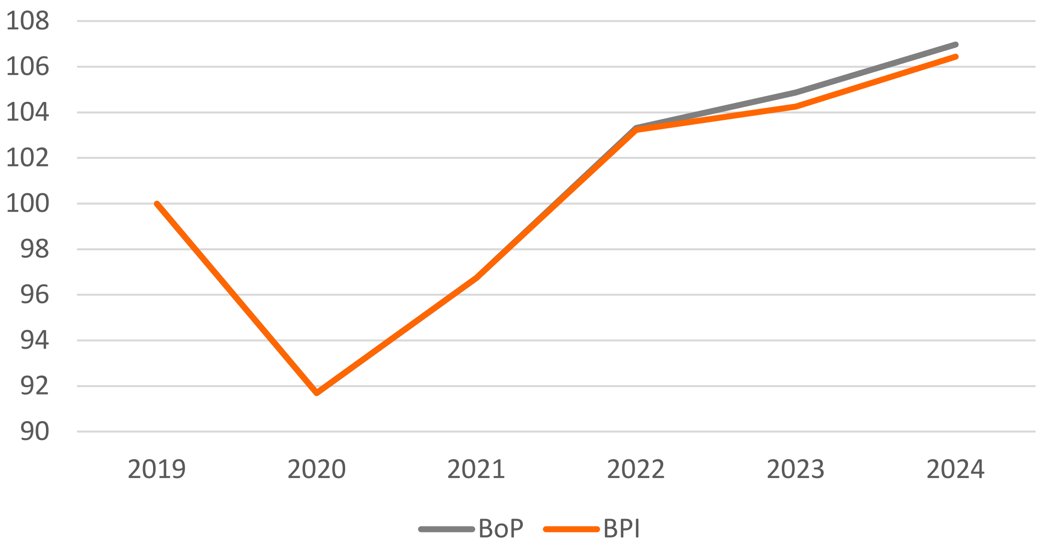
%

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 Jan-23		***6.7***	***1.0***	***2.1***	***10.0***
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 Jan-23		***6.0***	***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 Jan-23		***7.8***	***5.5***	***2.8***	***16.9***

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



- **Despite the updated scenario, BPI continues more conservative for growth in 2023; first economic data for 2023 suggests that deceleration may be more moderate than previously predicted.** Risks to our scenario seem balanced for now.
- **According to 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.

Labor market remains robust but should not be immune to a more adverse context

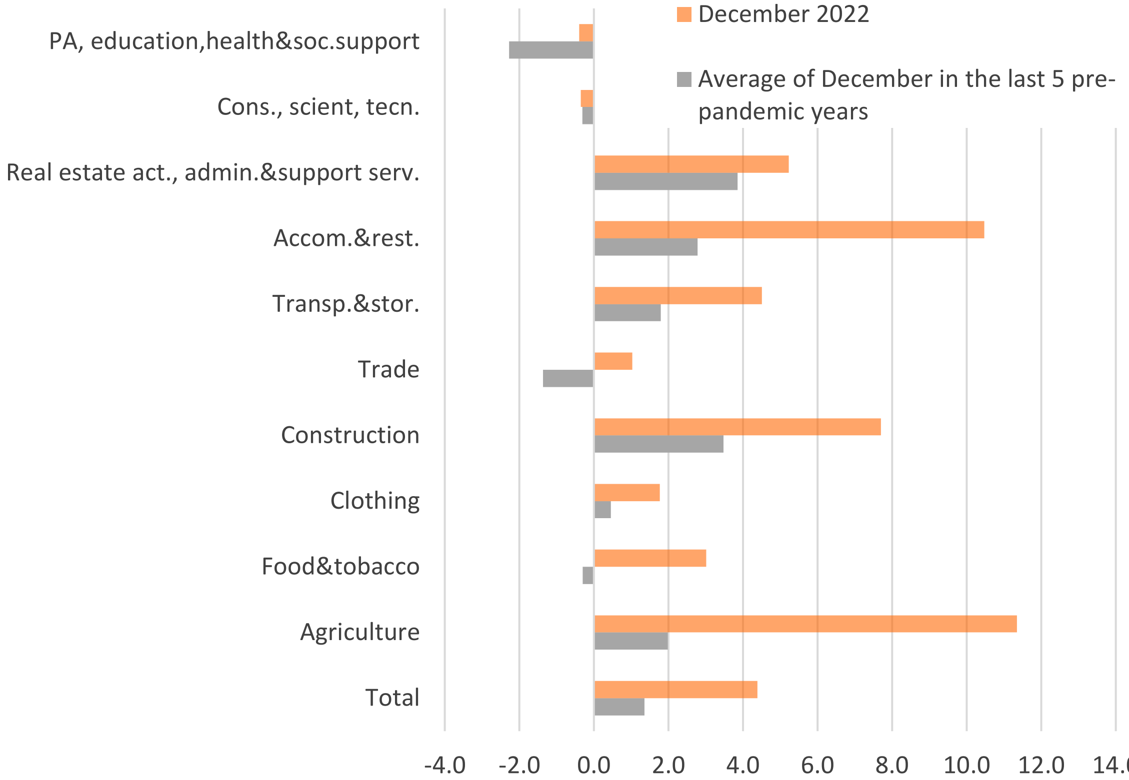
Registered unemployment*

Thousand people

Note (*): *not seasonally adjusted.* ***Source****: BPI Research, from IEFP.*

Registered unemployment by sector

Month-on-month change (%)



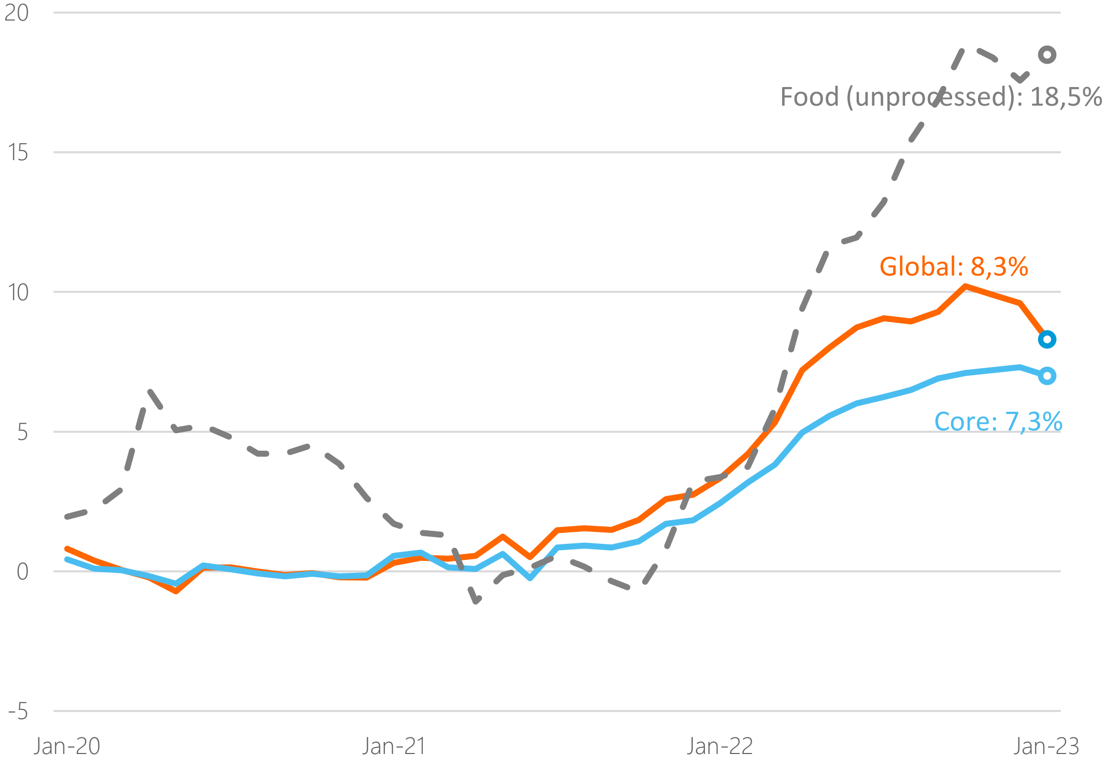
Note: *only the sectors with significant weight in the number of unemployed are represented. The average change rate recorded in December for the 5 years prior to the pandemic is presented.* ***Source****: BPI Research, from IEFP.*

- **Registered unemployment increased for the fifth consecutive month in December, although it remains at historically low levels**. **Some sectors have shown more alarming dynamics**, such as construction and accommodation & catering.
- However, **employment continues at high levels** (≈3% above 2019's level)**, confirming the tight labor market**. This is reflected in difficulties in hiring, mentioned by some sectors as an obstacle for the activity.

Inflation: some signs of easing

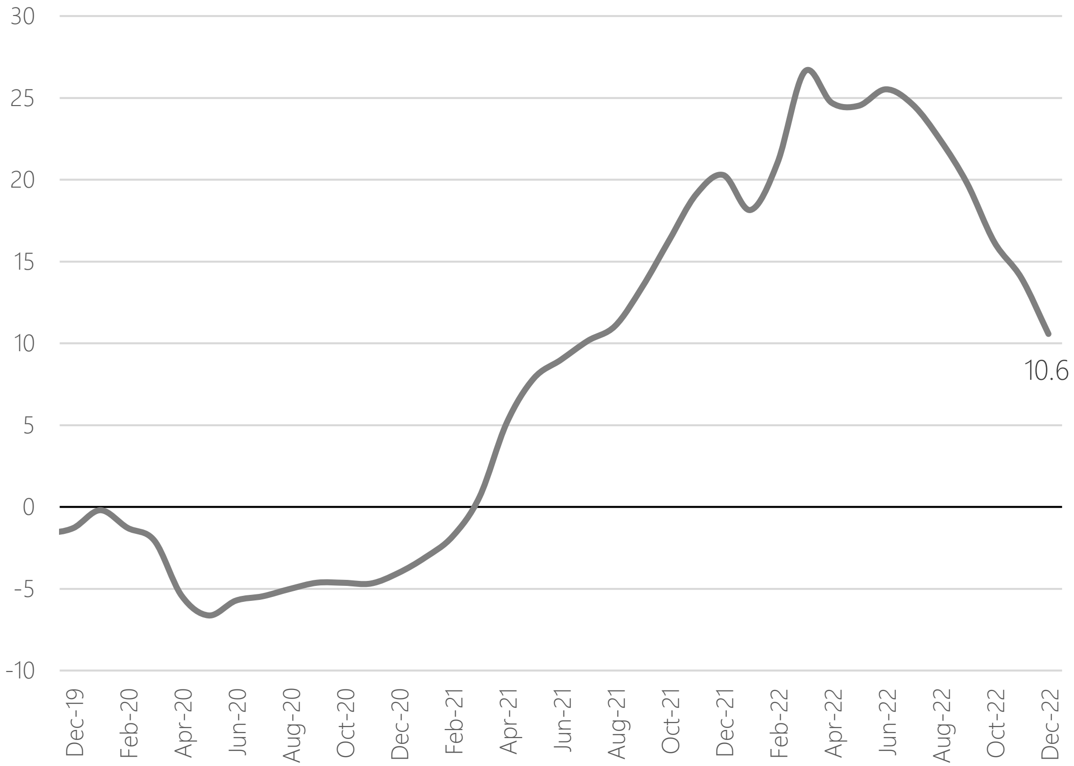
Portugue CPI: Global, Core, and Food

Year-on-year (%)



Industrial production price index

Year-on-year (%)

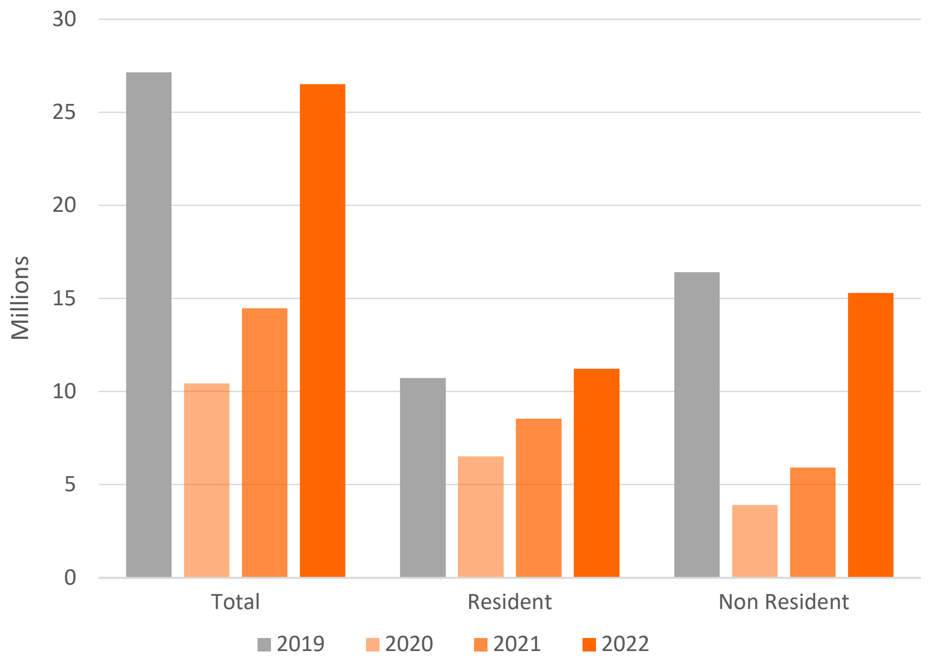


***Source**: BPI Research, using data from INE.*

- **Similarly to what happened in the Euro Zone, the Consumer Price Index for January 2023 decelerated for the third consecutive month, to 8.3% year-on-year, 1.3 p.p. less than in December.** The energy component fell by an extraordinary 9.1% in monthly terms, largely due to the decrease in electricity prices, giving a strong boost to the decline of the index as a whole.
- The most relevant data is the decline in the core index (excluding unprocessed food and energy) to 7% (7.3% in December). This component had risen for 15 consecutive months and may be a more consistent sign of a slowdown in price increases. On the other hand, although still at high levels, we see that the producer price index also continues to moderate and this should continue to support slowdown in consumer prices.
- **In the opposite direction, food prices returned to an upward trajectory**. In fact, the poor agricultural year in the country with relevant falls in animal and vegetable production should continue to put pressure on the price of these goods.

Tourism: resident guests and overnight stays surpassed 2019

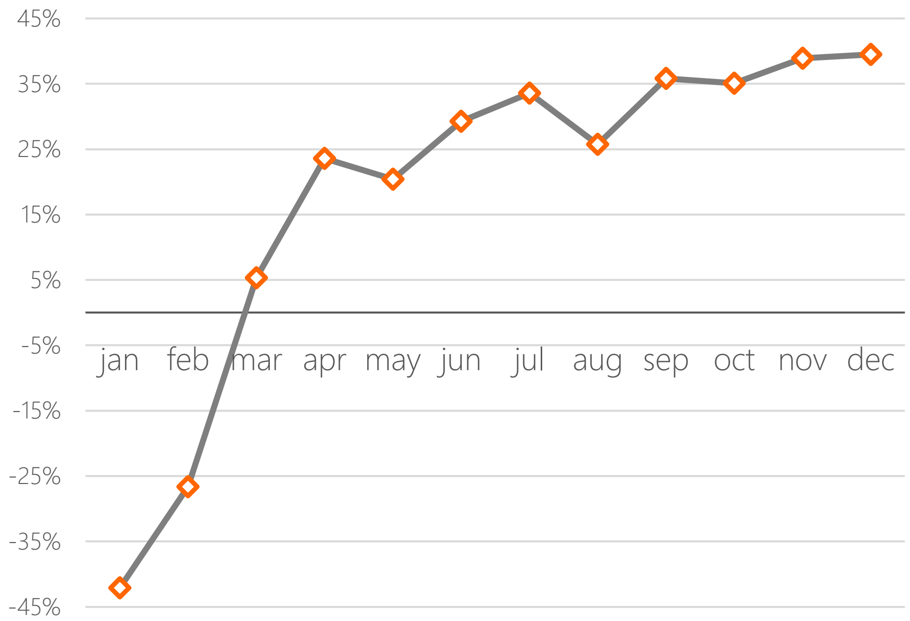
Number of guests



Source: BPI Research, using data from INE.

USA guests

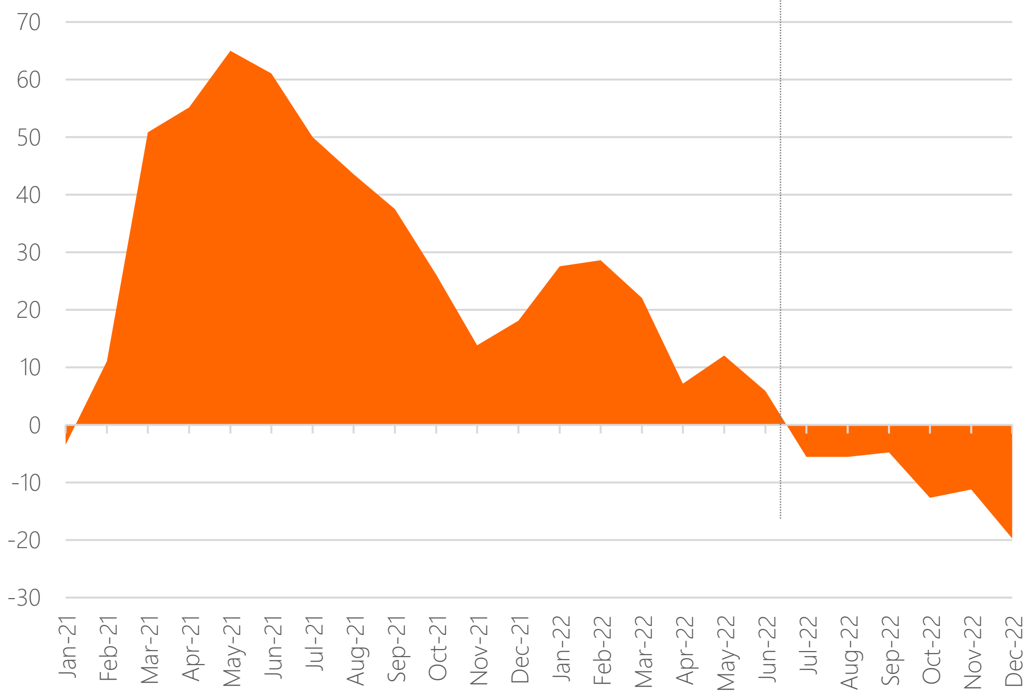
% change versus same month of 2019



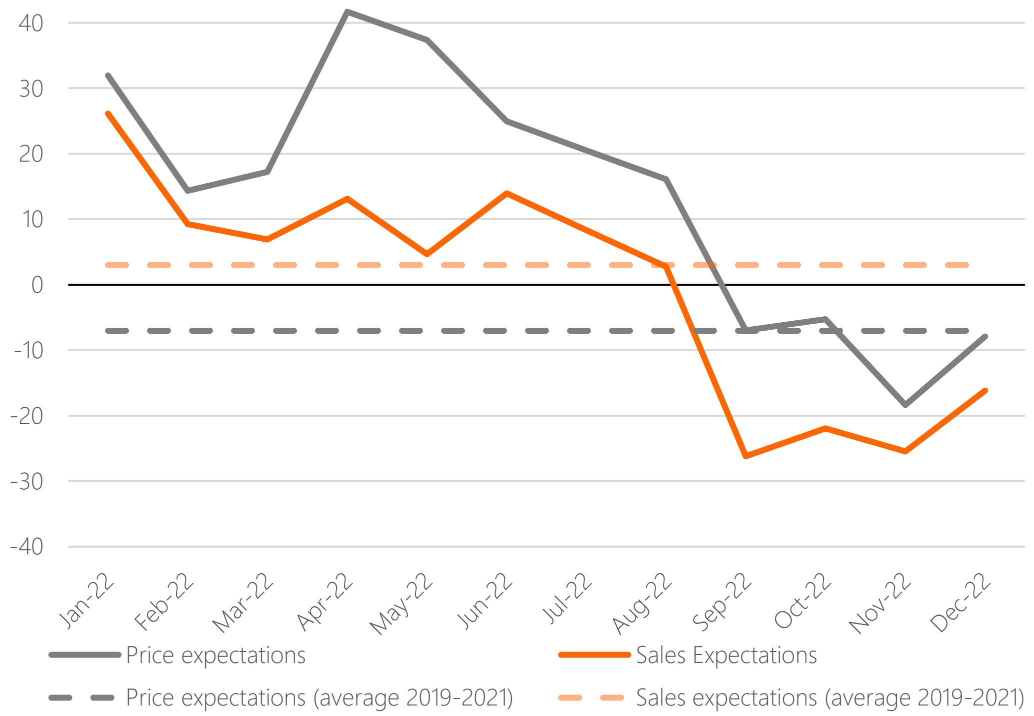
- INE's flash estimate shows that in the whole of 2022 (preliminary data), tourist accommodation establishments recorded 26.5 million guests and 69.5 million overnight stays, translating into increases of 83.3% and 86.3% (+38.6% and +44.7% in 2021, respectively). **Compared to 2019, guests decreased by 2.3% and overnight stays decreased by 0.9%.**
- **Overnight stays declined by 0.9% but with different behaviour between residents and non-residents: +8.6% for residents and -5.0% for non-residents.**
- **We believe that 2023 will mark the surpassing of the pre-pandemic figures both globally and also with regard to non-residents**. Events like the World Youth Day 2023 taking place in Lisbon and the outstanding performance from guests from USA support this idea.
- Also, the reopening of China (only in 2022 was possible to start travelling at home and abroad, with preference for neighboring countries) could play a leveraging role to our vision. In the period from January to November 2022, overnight stays by tourists from China in Portugal registered a significant growth compared to 2021 (264,4%) but still were 76% bellow 2019.

Housing market: More pessimistic mood among market players

New mortgage loan amounts
Yoy % change



Portuguese housing market survey
Balance of surveyors (%)

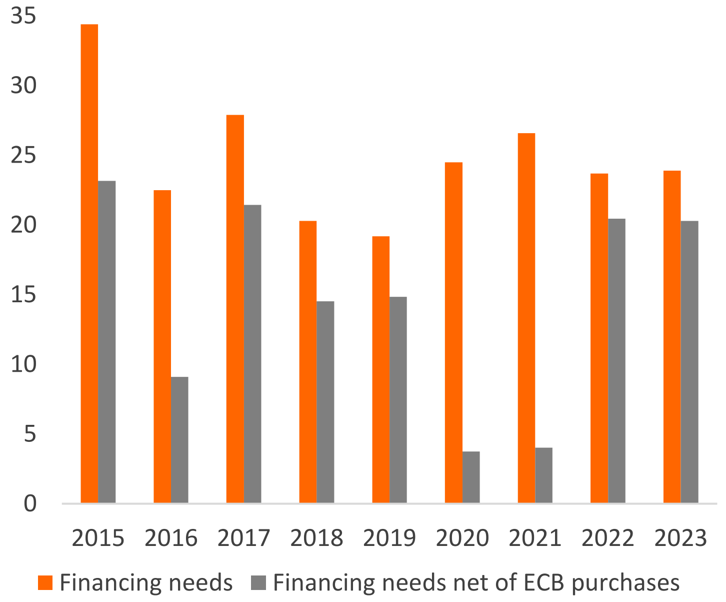


Source: BPI Research, using data from Banco de Portugal and Confidencial Imobiliário .

- **The slowdown in the housing market market is clearly evident in the amounts of new mortgage loans:** with the beginning of the monetary tightening cycle (July 2022) the year-on-year changes in new housing loans volumes have been increasingly negative (-19.7% yoy in last December).
- **The mood among real estate agents and developers regarding future sales and prices is in negative ground and bellow recent years average.** Still, we should note that expectations about prices are above the expectations about sales (and very close to 2019-2021 average level). This means that market players expect the market to cool down but with greater price inertia. Supporting this idea is a fairly resilient labour market and the shortage of housing supply in the market.

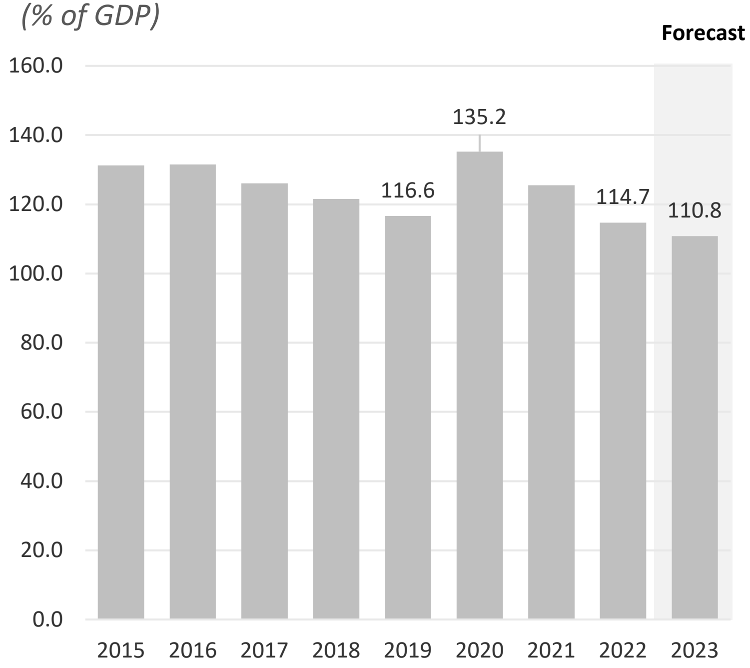
Prudent fiscal stance, the liquidity cushion and ECB reinvestments provide comfort in an uncertain environment

Funding needs
(Billion euros)



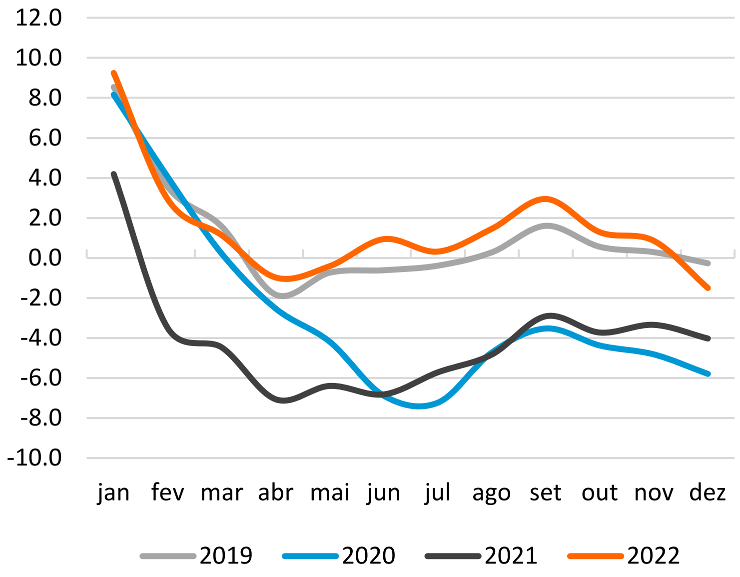
Source: *BPI Research, based on DGO and state budget 2023.*

Public debt ratio
(% of GDP)



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

Overall fiscal balance*
(% of GDP)

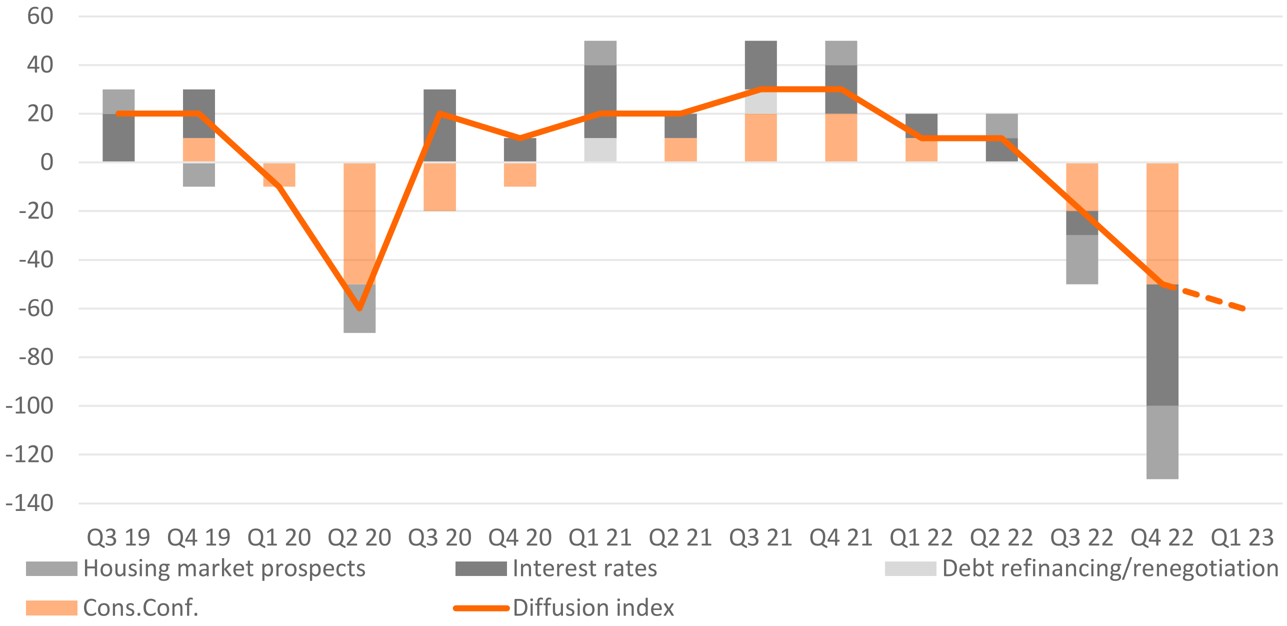


Note (*): *cash basis.*
Source: *BPI Research, from DGO data.*

- **Financing needs for 2023 amount to €24 bn.** In 2023 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 and positive growth dinamics. Still, the current liquidity cushion (public administration deposits, including the Treasury cash buffer) amounts to around €14 bn (c. 6% of GDP), comfortable according to historical standards.
- The sovereign risk premium has increased following the end of net asset purchases, but we expect it to remain within reasonable bounds supported by the ECB new anti-fragmentation tool, Government's commitment to fiscal consolidation and the positive evaluation from the several rating agencies.

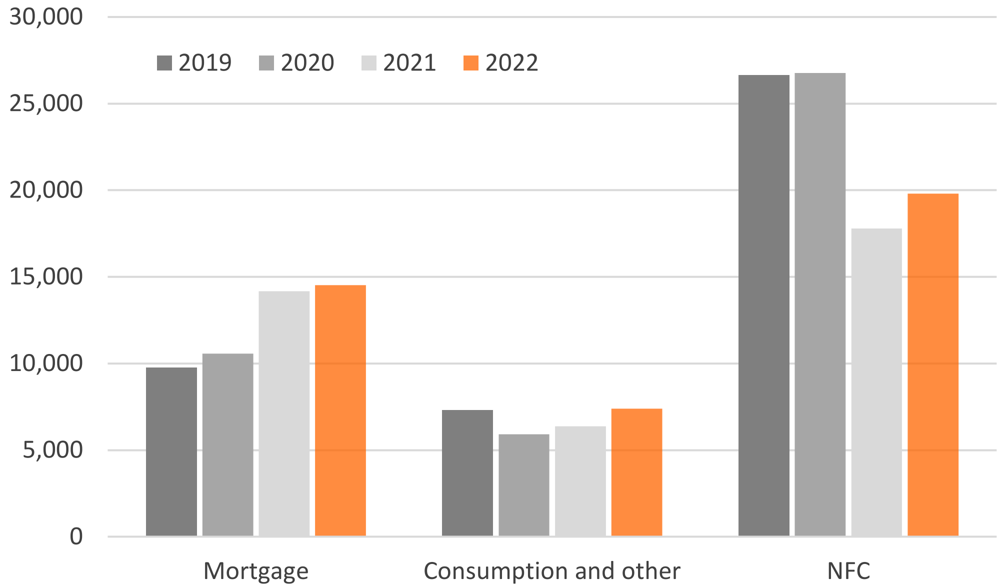
Banking system: a solid position to face the economic slowdown (1)

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, million euros



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

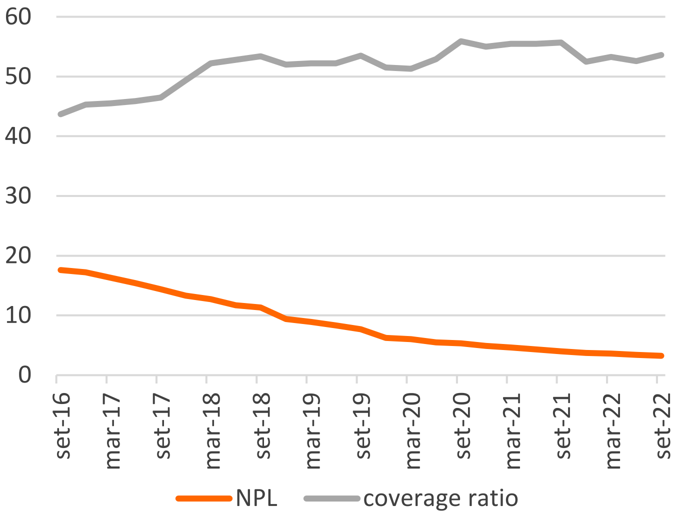
- **The end of moratorium justifies the return of the deleveraging trend in the private sector.** Corporate debt levels remain below euro area average despite the recent pick-up in credit outstanding (mostly due to state guaranteed credit lines). Household debt shows more gradual reduction, reflecting expanding mortgage lending.
- **New credit started to decelerate.** In 2022, new financing for NFC and households increased (11.3% and 6.6%, respectively), but is showing signs of deceleration, especially mortgage credit. In fact, in the second part of 2022, housing credit decreased ≈10% yoy, but continues at higher levels than the average seen in 2019 (+49%).
- **Banks are anticipating lower demand for credit in Q1**. Increasing interest rates, higher inflation rate, lower confidence and housing prices at significant values 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

NPL ratio[1]
In % of gross loans

Coverage ratio
In % of NPLs



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

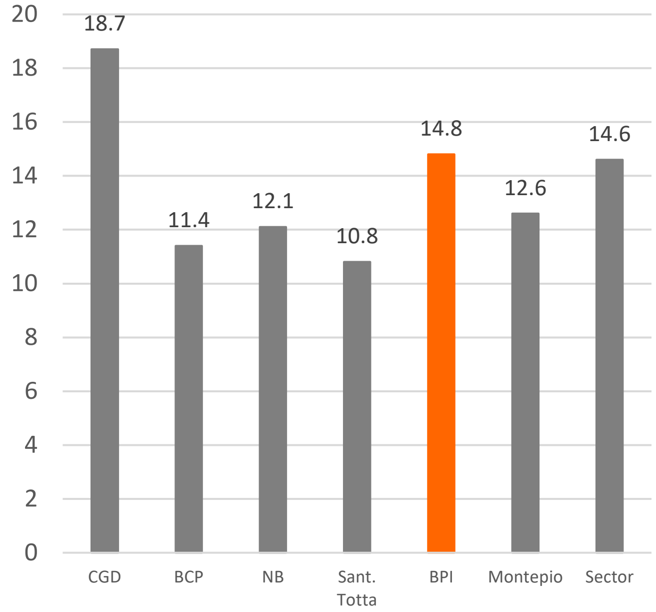
In % of average total assets (Q3 22; trailing 12M)

	BPI*	BCP	San Totta*	CGD	NB	Montepio
Net interest income	**1.3%**	**1.3%**	**1.3%**	**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%	0.2%	0.2%
Other net profits	-0.1%	-0.1%	0.0%	0.0%	0.4%	-0.1%
Gross income	**2.1%**	**2.3%**	**2.2%**	**1.5%**	**2.4%**	**1.8%**
Operating expenses	-1.1%	-0.9%	-0.8%	-0.7%	-0.9%	-1.2%
Operational result	**0.9%**	**1.4%**	**1.4%**	**0.8%**	**1.5%**	**0.6%**
Impairment losses, taxes and others	-0.2%	-0.5%	0.0%	0.3%	-0.1%	-0.2%
Profit	**0.6%**	**0.6%**	**1.0%**	**0.8%**	**1.3%**	**0.2%**
ROTE[1]	8.0%	2.5%	12.3%	10.8%	nd	nd

***Notes**: 1) the values for BCP and CGD refer to ROE; calculation methodologies differ between banks. * data for 2022*

Banks' solvency and liquidity position

*In % (Q3 22)**



***Source**: Banks publications, BoP*
**Q4 for Santander Totta and BPI*

- **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.

BPI

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