Rating Update:

Creditreform Rating revises Portugal's outlook to "stable", while affirming its ratings at "BBB"

Rating Action

Neuss, 03 April 2020

Creditreform Rating has revised its outlook on the Republic of Portugal to "stable" from "positive" and affirmed the unsolicited long-term sovereign rating of "BBB". Creditreform Rating has also affirmed Portugal's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "BBB".

Reasons for the Outlook Revision

The outlook on the Republic of Portugal has been revised from positive to stable, reflecting our expectation that

(i) economic developments will weaken significantly in the near term, accompanied by a deterioration in labor market conditions, before presumably entering a recovery; and

(ii) the improvement in the sovereign's public finances will come to a halt, mainly reflected in an ad hoc increase in the public debt ratio, although the latter should resume its downward trend over the medium term; however, fiscal risks have generally risen against the backdrop of heightened volatility in government bond yields and potentially re-emerging uncertainty over banking stability.

Medium-term growth trajectory interrupted by Covid-19

While the effects of Covid-19 seriously dampen our short-term outlook, it is not possible to predict the scope at this stage. This will depend on the full range of measures being taken to combat the virus. Ultimately, the duration of the shock is contingent on the development of effective medicines and on the effect of the policy-measures in place to contain its impacts. To our understanding, measures to combat the fallout from the pandemic include a EUR 9.2bn aid package announced by the government on 18 March (~ 4.3% of GDP). The package comprises fiscal measures, including deferral of tax payments for companies and self-employed, reduction of social contributions, and suspension of tax or contributory enforcement proceedings. Also, authorities adopted labor market support initiatives, such as extraordinary extension of unemployment benefits and all benefits of the social security system. Furthermore, extensive liquidity support was provided to the corporate sector, e.g. credit lines targeted towards micro enterprises and SME in the prospectively hardest hit sectors (tourism, industry, food and accommodation).

Our baseline scenario assumes a more or less U-shaped pattern of economic development. At present, we expect Portuguese real GDP to decline by 3.0% in 2020, followed by a pick-up of 3.2% in the next year. While the Portuguese economy appears set to contract in the first half of the year, the course of the economy in H2-20 depends on whether the restrictions continue or are eased or lifted towards the summer.

Before the corona crisis fully struck, consumer confidence was still holding up well, suggesting that private consumption would have been set to remain growth supportive, although to a somewhat lesser extent given the slowdown in job creation. We now assume that household spending will decline in 2020. In light of the corona pandemic, labor market conditions are likely to cloud substantially. Despite measures geared towards supporting workers' incomes and bolstering corporate liquidity, layoffs seem inevitable, and we expect employment and wage growth to pull back, resulting in lower real disposable incomes, with the effects cushioned by low HICP inflation. What is more, households should be more inclined to save in view of highly uncertain economic prospects.

In Q1-20, export expectations had dropped to their lowest level since 2013, already pointing to further export weakness and a continued negative effect from net trade going forward. The pandemic is set to curb external demand and final demand for imported goods and services. Arguably most importantly, Portugal's large tourism sector, included in a relatively high gross value added share of trade, transport, food and accommodation activities (24.9% as of Q4-19, EA: 19.0%), is bound to take a hard hit. In such a scenario, investment activity is set to experience a severe setback, reflecting postponed corporate investment decisions as well as a prospectively sharp decrease in industrial production, adversely affected by direct supply disruptions and subsequent supply-chain contagion via Asia and other key industrial economies in the euro area.

Improvement in the sovereign's public finances temporarily coming to a halt

Having reached a headline surplus a year ahead of schedule in 2019, indications for a balanced budget in 2020 seemed quite promising before the corona virus outbreak. In view of the pandemic, we expect the fiscal position to deteriorate, with the headline balance to come in significantly worse than the originally budgeted 0.2% of GDP (DBP 2020, Dec-19). Against the backdrop of the initial emergency package, we tentatively estimate a headline deficit of approx. 3.7% of GDP. Risks to the estimate are clearly skewed to the downside, as we assume that guarantees will not be fully utilized and we cannot rule out that further support measures will follow. While substantial fiscal support should cushion the most detrimental effects on the real economy, we believe that the decline in general government debt should come to a temporary halt due to the extensive measures, before resuming its downward trend beyond 2020.

In general, fiscal sustainability risks have risen. Public debt could remain at its current high level, in particular if further fiscal support was deemed necessary. Moreover, the Portuguese banking sector could face severe difficulties, if policy-makers fail to minimize the economic fallout, entailing further fiscal risks. Whilst asset quality and profitability have been improving over the last years, Portugal's banks still appear vulnerable to a prolonged economic slowdown.

In the current environment of high uncertainty on financial markets, financing cost issues have returned to the fore, in particular with regard to countries such as Italy, Spain, and Portugal. We believe that avoiding a loss of confidence on financial markets and an associated sharp rise in interest rates is key, not only to create fiscal leeway to finance the necessary measures, but to prevent Portugal from being cut off from capital market access. To be sure, Portugal successfully issued a PGB 7yr syndication on 1 April, with a total amount of EUR 5bn. Before the outbreak of the corona crisis, market conditions for Portuguese sovereign debt had been very favorable, with 10y bond yields standing at historically low levels (04-Mar-20: approx. 0.2%). Since then, these have risen rapidly to roughly 1.4% on 18 March, but fell markedly in reaction to the ECB's

comprehensive emergency response to the crisis (30-Mar-20: approx. 0.6%). The ECB announced a Pandemic Emergency Purchase Program (PEPP) with an envelope of EUR 750bn, on top of increased net asset purchases to the tune of EUR 120bn under the existing asset purchase program (APP) until the end of the year. Still, we will monitor market conditions vigilantly.

Reasons for the Rating Decision

Apart from the substantial uncertainties currently weighing on prospects for the Portuguese economy due to the corona crisis, an otherwise robust macroeconomic performance in our view remains balanced to a certain degree by a subdued medium-term growth outlook owing to still elevated albeit decreasing non-financial corporation (NFC) debt, which could restrain investment activity, as well as to comparatively low productivity.

Portugal's economic growth remained solid; having softened from 2.6 to 2.2% in 2018-19, it nevertheless outpaced euro area real GDP growth by a substantial margin (2019: 1.2%). Private consumption growth lost momentum over 2019 (2.3% after 2.9%), but represented the main pillar of GDP expansion amid robust wage growth and low inflation. Gross fixed capital formation saw accelerated growth (6.3% after 5.8%), but only due to a strong Q1-19. Over the following quarters, annual growth rates in investment shrank to 2.1% in Q4-19 on the back of a challenging external environment. In this context, net trade turned out to be a drag again, with export growth slowing to 3.7% (2018: 4.5%) and import growth moderating to 5.2% (2018: 5.7%).

We note that Portugal's solid output expansion translated into higher – albeit in a euro area comparison still subdued – levels of wealth, with GDP per capita (PPP levels, IMF data) amounting to USD 33,665 in 2019, or 76% of the weighted EU-28 average (2018: 75%). Portugal's market share in global exports edged up from 0.42% to 0.43% in 2017-18, its highest level since 2007, suggesting further gains in competitiveness.

In 2019, the unemployment rate decreased to 6.5% (EA average: 7.6%), whilst employment growth slowed markedly to 0.8% in 2019 (EA: 1.2%), from 2.3% in 2018. However, the ongoing, although decelerating, labor market recovery may end rather abruptly in the face of the substantial challenges associated with the corona crisis.

NFCs have engaged in further deleveraging since our last review, but still display a high debt level (Q3-19: 86.6% of GDP, acc. to IGCP) as compared to other euro area members. Hence, we would continue to view risk-bearing capacities as constrained and medium-term perspectives for private investment as somewhat muted. Arguably, this adds to perceived shortcomings in investment in transport infrastructure as well as in R&D, thus increasing the risk of hampering potential growth. Also buttressing our slightly cautious medium-term outlook is the fact that Portugal's economy has been lagging behind in terms of labor productivity as measured against EU-28 levels, notwithstanding more robust real labor productivity growth in 2019 as compared to the previous five years (2019: 1.4%, 2014-18 average: 0.1%).

Portugal's credit ratings continue to mirror the generally high quality of its institutional framework. The sovereign's institutional strength is mainly reflected in the latest edition of the World Bank's Worldwide Governance Indicators (WGIs). Portugal thus shows a solid performance across the WGIs we consider, in particular as compared to other former program countries. Compared to the respective euro area averages, Portugal's WGI performance is broadly on par, with the notable exception of government effectiveness, where Portugal ranks 29th out of 209 (EA median: 36), indicating a relatively high quality of policy formulation and implementation.

Although the parliamentary elections held in October 2019 resulted in a minority government led by the incumbent Partido Socialista (PS), which had emerged as the strongest party, we do not consider the effectiveness of the newly-formed government to be at risk and assume broad policy continuity; not least as the last minority government under PM Costa had demonstrated political clout during its previous legislative term. Indeed, as illustrated since the outbreak of the corona crisis, authorities have acted swiftly, managing to organize the necessary parliamentary support.

Despite considerable consolidation effort, risks to the sovereign's fiscal sustainability continue to be its main credit weakness, which is mainly due to very high government debt and elevated, though falling, interest expenses, as well as contingent liability risks related to the banking sector.

Driven by solid economic growth, the benign interest rate environment and increasingly sound fiscal policies, the headline budget has persistently improved over the years. According to INE Portugal data, the sovereign recorded a headline surplus of 0.2% of GDP in 2019, up from -0.4% of GDP in 2018 and the first surplus since Portugal's transition to democracy. As suggested by provisional data, last year's improvement was largely driven by buoyant tax revenues and spending discipline of the government. Coming in at 3.8%, revenue growth thus outpaced that of general government expenditure (2.3%). Robust economic activity and favorable labor market conditions resulted in significantly higher social contributions, which rose by 6.3%, and to a modest increase in current taxes on income and wealth (+0.9%). On the spending side, social benefits other than social transfers in kind increased by 3.8%, whilst the public wage bill expanded by 4.4%. These increases were somewhat balanced by a substantial decline in interest outlays that dropped by 7.5%; the early repayment of EFSF loans which would have matured in 2025/26, proved beneficial in this respect.

Accordingly, general government gross debt declined markedly, from 122.0% of GDP in 2018 to 117.7% of GDP in 2019, still representing one of the highest readings in the EU. Debt affordability continues to compare unfavorably among EU countries, with interest payments accounting for 7.0% of general government revenue (2018: 7.9%).

Banking sector stability has continued to improve. However, with the NPL ratio at 8.3% (Q3-19, EBA data; Q3-18: 12.0%), asset quality is still ailing from a European perspective (EU average: 2.9%). While CET1 ratio of Portuguese banks has been broadly stable over recent quarters, it also remain sub-par at 13.4% (EU: 14.6%). Banco de Portugal (BdP) data for the whole banking sector in Q4 shows that the NPL ratio reached 6.1% (Q4-18: 9.4%), and the CET1 ratio 14.1% compared to 13.2% in Q4-18. We note that EUR 1.9bn of the total EUR 3.89bn under the Contingent Capital Agreement were already executed over 2018-2019 with regard to Resolution Fund payments to Novo Banco.

Having become more open to international trade over recent years (trade-to-GDP 2019: 87.7%, 2014: 80.3%), Portugal's economy remains vulnerable to risks emanating from the external sector. The net international investment position (NIIP) posted at -100.8% of GDP in 2019, significantly less negative than the previous year's level (-5.3 p.p., BdP data), but still among the most negative readings in the EU. The current account slipped into a slight deficit, declining to -0.1% of GDP in 2019 (2018: 0.4% of GDP), mainly due to a narrowing trade in services balance (8.5 to 8.2% of GDP). Looking ahead, we expect that the Corona pandemic will deal a serious blow to Portugal's tourism industry, which should result in a negative impact on trade in services. Yet,

the impact of the services balance on the current account should be somewhat mitigated by plunging oil prices.

Rating Sensitivity

The outlook for the long-term credit ratings of the Republic of Portugal is stable, as we expect the risk situation underlying the main factors affecting sovereign credit risk to remain fundamentally unchanged over the next twelve months. However, the assessment and interpretation of economic developments in the near future is much more challenging than under normal circumstances, as is the case for other indicators, given the current considerable uncertainty in the economy and financial markets and the very dynamic development of Covid-19.

Downward pressure on Portugal's ratings or the related outlook could arise if medium-term growth is adversely affected, which could be the case if the detrimental effects of the corona pandemic extend well into the second half of the year and beyond, and if policy-makers fail to minimize the economic fallout. We could also consider a downgrade if the interruption of the downward trend in Portugal's debt-to-GDP ratio is not transitory and we see the public debt trajectory reverse, and/or if contingent liabilities stemming from the banking sector materialized.

We could raise the sovereign's ratings if medium-term growth surprised on the upside, if the negative labor market effects of Covid-19 turn out to be short-lived, if the government is able to implement structural reforms to enhance the economy's external competitiveness and its medium-term growth potential on a sustainable basis, and/or if we perceive that crisis legacies in the banking sector are no longer an issue, thereby reducing contingent liability risks.

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Ratings*

Long-term sovereign rating	BBB /stable
Foreign currency senior unsecured long-term debt	BBB /stable
Local currency senior unsecured long-term debt	BBB /stable

*) Unsolicited

Economic Data

[in %, otherwise noted]	2014	2015	2016	2017	2018	2019e	2020e
Real GDP growth	0.8	1.8	2.0	3.5	2.6	2.2	-3.0
GDP per capita (PPP, USD)	27,301	28,197	29,156	30,822	32,412	33,665	34,936
HICP inflation rate, y-o-y change	-0.2	0.5	0.6	1.6	1.2	0.3	0.1
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	81.3	81.3	81.3	81.6	81.5	n.a.	n.a.
Fiscal balance/GDP*	-7.4	-4.4	-1.9	-3.0	-0.4	0.2	-3.7
Current account balance/GDP	0.2	0.2	1.2	1.3	0.4	-0.1	n.a.
External debt/GDP	231.0	217.1	206.9	201.8	196.8	n.a.	n.a.

Source: International Monetary Fund, Eurostat, Banco de Portugal, INE Portugal, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	28.10.2016	BB /stable
Monitoring	27.10.2017	BB+ /stable
Monitoring	21.09.2018	BBB- /positive
Monitoring	23.09.2019	BBB /positive
Monitoring	03.04.2020	BBB /stable

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. Agência de Gestão da Tesouraria e da Dívida Pública (IGCP) participated in the credit rating process as IGCP provided additional information and data, and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of IGCP during their review. However, the rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology in conjunction with its basic document "Rating Criteria and Definitions". CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank,

Agência de Gestão da Tesouraria e da Dívida Pública – IGCP, Banco de Portugal, Direção-geral da administração e do emprego público (DGAEP), and Instituto Nacional de Estatística Portugal.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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