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Portugal: Out of the red and into the green?

Until recently, Portugal was commonly viewed as one of the weak links in the EU – a peripheral nation more likely to hamper economic progress, rather contribute to it. The country's 'Great Recession' from 2010-14 left it unable to refinance its government debt without the assistance of the IMF and the EU who provided a bailout of €79 billion (Bn) to keep the economy afloat. However, six years down the line, though there are challenges ahead, the nation's prospects are firming.

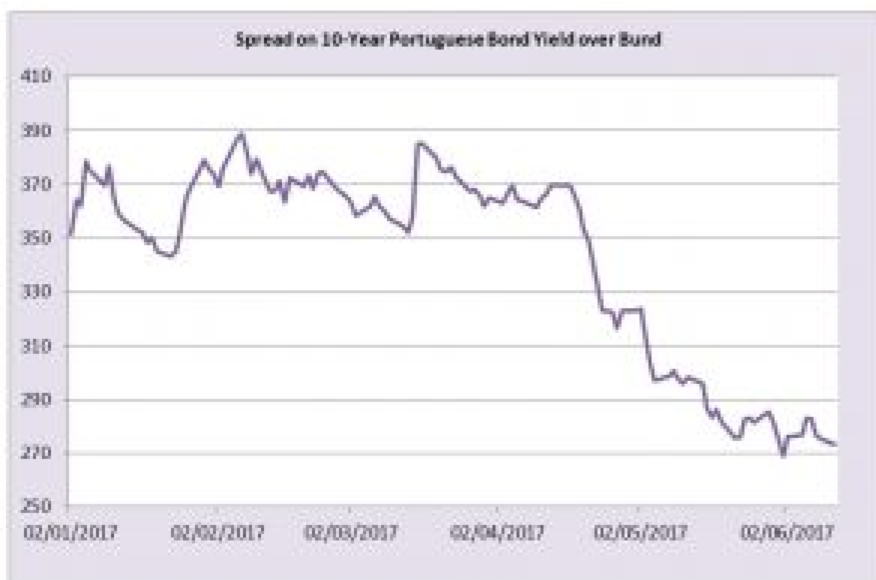
In the first quarter of 2017, Portugal's gross domestic product (GDP) expanded at an annual rate of 2.8% - twice as fast as the eurozone average. This was fuelled by recovering investment and increased exports (which hit an all-time high of €5.26Bn in March). The Portuguese tourism industry is booming, as is the real estate market.

But the success story goes further... Portugal has emerged from the ECB's mechanism for fiscal discipline after reducing its budget deficit to 2.1% of GDP; comfortably below the EU's 3% threshold. This was a big success for the Socialist Prime Minister António Costa - the deficit was

7.2% in 2015 when he came to power.

Between 2011 and 2014, 485,000 Portuguese workers (roughly 9% of the labour force) left the country. To address the country's 'demographic time-bomb' and dilute the effects of emigration on the future labour force, the parliament is debating changes to Nationality Laws to grant all children born in Portugal the right to jus soli (citizenship). Portugal needs 75,000 new adult immigrants per year, while trying to stop the departure of working age Portuguese, especially the young.

In light of recent successes and fading political risk across Europe, Portugal's bond yields are falling. The spread on 10-year Portuguese Government bonds over the German Bund has narrowed to just above 270 basis points (bp). Our analysts believe a 200bp spread would be adequate, demonstrating a return to pre-2011 levels.



Source: Bloomberg, BIL

At present, only one small Canadian agency, DBRS, rates Portuguese Government bonds as 'investment grade'. The best case scenario would be if Portugal's credit rating was upgraded from 'junk' status by other agencies in Autumn at the next set of reviews, which should lower yields further.

However, ratings agencies may be reluctant as the Government debt to GDP ratio is 130% - the second highest in the eurozone after Greece. Moody's believes this will start declining to reach 125% of GDP in 2020. Portugal is demonstrating progress and recently requested permission from the EU to re-pay an extra €10Bn which it owes to the IMF in advance.

Nonetheless, there are also concerns around weaknesses in Portugal's banking sector which saw profits fall 7% in 2016, with non-performing loans (NPL) comprising 1.6% of banks' total assets.

For now, we believe that Portugal's progress galvanises the case for European equities in general, demonstrating a more broad-based recovery across the region, and further diminishing the risk of a fallout within the EU. There are several key events this year which will be instrumental in determining whether the country's recovery can persist and give investors the green light to invest directly in Portugal; the Novo Banco/ Lone Star deal being finalised before the deadline, and for rating agencies to upgrade Portugal's sovereign rating. The main agencies will now assess whether enough has been done to strengthen the banking sector and whether a falling debt trajectory (slowly though it may be) builds a convincing case for Portugal to wear its coveted investment grade hologram once more.

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