RESEARCH DEPARTMENT

RISK OUTLOOK

June 2015
Index

1. EXECUTIVE SUMMARY 3
2. MACROECONOMIC REPORT 8
3. SECURITIES MARKETS INDICATORS 29
   Equities & Equity Futures – selected indicators 29
   Bonds & Credit Derivatives 35
   Investment Management 41
   Trading 45
4. LOOKING AHEAD AND CONCLUDING REMARKS 48
5. LIST OF GRAPHS 53
1. Executive Summary

By early May 2015, the economic recovery of the Eurozone remains fragile, but the prospect of the economy picking up has some traction in the data. Nevertheless, important caveats must be recognised. Not long ago, in late 2014, along with the problems related to Greece’s public debt management, a flight-to-safety was noticed, with more investors turning to treasuries and sovereign bonds.

The latest World Economic Outlook (April 2015) reveals a slightly more optimistic but still prudent IMF: “(...)The distribution of risks to near-term global growth has become more balanced in relation to October 2014 but is still tilted to the downside. (...)”. The European and Japanese economies risk experiencing a period of economic stagnation. Economic developments in emerging economies are not promising and are driven by low growth prospects and a decline in commodity prices.

The latest figures from the US GDP, along with the very latest PMI indexes from Markit (April 2015) for Europe, reveal an unexpected underperformance, hinting that the probable higher GDP growth rate in 2015Q1 may not be followed by a similarly strong 2015Q2. These figures give some substance to the questions on the limits of the current growth cycle in developed economies. A question that resonates with the most recent advice from several international financial institutions on the need for a comprehensive policy approach to the economy, given the existing evidence that markets are repeating behaviours that led to the last financial crisis.

In early 2015, the ECB’s assessment of the Eurozone (EZ) remains cautious. The risk of low inflation in the medium-term led the ECB Governing Council to announce additional non-standard monetary measures in January 2015 (to be deployed in March), despite the lack of unanimity, with some members advocating a “wait and see” option. The ECB finally promised to arrange a €60 billion per month quantitative easing plan for the next couple of years.

Oil prices continued a downward trend in 2015Q1, with Brent’s price dropping by more than 50% in one year, only to slightly rebound, hovering about a loss of 40% by early May. The euro depreciated against the dollar by about 20% in one year (early May data). The external trade balance in the EZ maintained a clear and stable surplus and the GDP managed to return to positive values in 2014 (+0.9%). Moreover, the stock market bloomed in the first four months of 2015, with at least a seven-year record high, when considering the 300 largest European companies. Sovereign debt yields fell to nominal all-time lows in a number of European countries.

The still recent market turmoil shows the frailty level in several markets and economies, most affected by the crisis that started seven years ago. Confidence in a better outlook for these economies, such as the Portuguese, is not being fully supported by economic fundamentals. The low oil price and
geopolitical instability have taken a toll in some of the most recent and important buyers, leading to a steep fall in Portuguese exports to several countries. A trend that the Portuguese economy, at least for the time being, has not managed to counterbalance by gaining enough market share elsewhere. One of the key questions for 2015 is whether exports will regain momentum, as the European Commission predicts in its spring 2015 economic forecasts.

For Portuguese CEOs, the lack of demand continues to be the single most important difficulty for the development of economic activity and the threat of diminishing profitability also seems to be dampening investment prospects. On a brighter note, there are now positive prospects for the labour market for 2015.

Another key issue is determining the extent to which the decrease in investments that marked the Portuguese economy since the 2008 crisis is to blame for a seemingly sluggish recovery, when compared with some of Portugal’s most important economic partners. Data from the European Commission also reveals that, in 2014, the stock of capital per employee in Portugal is just about half the EZ average, comparing badly to the so-called peripheral countries (Greece, Spain, Ireland and Italy). For the time being, the Portuguese economy seems to be dragging along, unable to fully take advantage of the low oil price/low euro combination.

The latest data on non-performing loans in Portugal, both for non-financial corporations (NFC) and for households, kept beating previous historical highs, albeit with lower increments among NFC and following an apparently stable rule of thumb: the larger the loan, the higher the number of non-performing contracts. Taking a closer look at private corporations by size of workforce and non-financial holdings, only micro-, small- and medium-sized enterprises (SME) are now clearly below the respective indebtedness level of late 2007. According to recent analyses by Banco de Portugal, most of the deleveraging among private corporations occurred in the context of debt write-offs resulting from bankruptcies (particularly in the real estate and construction sectors) and only a minor fraction comes from actual deleveraging of enduring companies. A situation that Banco de Portugal expects will endure in the coming years. New bank loans have been slowly decreasing, although with high volatility. Thus, the higher indebtedness, mainly among large corporations and non-financial holdings, even with GDP growing again, could only be explained by a higher issuance of debt securities and trade credits. This is not necessarily happening with SMEs. The conclusion of a still fragmented access to capital markets is strengthened by the sustained - if not increasing - small versus large loan interest rate spread and the absence of SMEs from stock markets. Moreover, even though nominal interest rates have been clearly decreasing, the real cost of money has been increasing.

For Portuguese households, the credit crunch has been ongoing for more than four years now and there has been a slow but stable deleveraging.

The real estate market is one of the focal points for
risk transmission across multiple sectors. The high real estate market illiquidity, combined with non-performing loans has put banks under stress and brought about potential conflicts of interest in highly verticalised financial groups with stakes in insurance, mutual funds and asset management, and even regulatory arbitrage. Nonetheless, the recent increase in prices has been barely accompanied by banking appraisal values, which signals that banks are still very prudent and probably not as important as market players as they were in the past.

The frequently quoted sentence that the EZ is recording historically low interest rates and, more generally, a historically low price of money must be taken with caution. Even though the 10-year sovereign yields in Portugal have been at the lowest nominal value in history, the 12-month Euribor spread (a usual reference for return on savings deposits) makes sovereign yields – ceteris paribus – much more attractive now than before 2009. When sticking to comparing the same class of investments, the yield of Portuguese 10-year sovereign bonds maintains a spread vis-a-vis Germany that is still clearly above its level prior to the financial crises or even after. Furthermore, upon entering a protracted low inflation period combined with low growth, austerity weariness in several EZ countries and important political dissent within the EZ could erode the sovereigns’ ability to maintain the fiscal revenue at the levels required to service the debt, which may threaten the EZ’s integrity. Against this background, monetary policy instruments intended to fight deflation risks could turn out to be themselves a risk factor. Achieving real economy yields, which divert investments from search-for-yield and bubble-prone markets seems to be critical at this point.

Another looming risk that should be stressed comes from market-based financing. It has been signalled as a significant risk, namely in China and in the USA, and it is being tracked with increasing interest in Europe. The European Commission has put forward a plan to build a Capital Markets Union, responding to calls for the strengthening of the internal market of financial services, the diversifying of funding sources and the mitigation of the effects of the banking crisis on taxpayers. However, in its current version, it is strikingly omissive (for instance, it fails to address fiscal terms), which advises moderate enthusiasm regarding its effectiveness.

Against the backdrop of increasing liquidity provisions, almost all the major stock exchanges (including the Portuguese) have begun to gain value. Volatility has clearly decreased in the first months of 2015 in most financial markets. The use of internet searches as proxies for the spontaneous behaviour of agents reveals an increasing interest for negative terms in the second half of 2014, probably due to the recent news about Portuguese banks. Over 2015Q1, the search for positive terms was stronger. Meanwhile, the Economic Sentiment Indicator for the Portuguese economy recorded a seven-year maximum in March 2015.

The Cyclically-Adjusted Price-Earnings Ratio (CAPE) for the Portuguese Stock Exchange was
below 14 at the end of 2014, which contrasts with the value observed in 2014Q1 (18.7). Additionally, Portugal’s Composite Indicator of Systemic Stress (CISS) has trended upwards in the eight-month period ending in February 2015, reaching lower figures in March. The increasing level of systemic stress during this period stems mainly from the financial intermediaries segment and from the equity market, and may be justified by extraordinary events that affected two prominent firms of the PSI20 index.

With regard to bond and credit derivatives, QE programmes exert a downward pressure on bond yields. Threats of deflation triggered the ECB to massively purchase sovereign bonds in secondary markets, and sovereign yields witnessed a sharp fall (particularly after March 2015). Bond yields are reaching historical nominal minimum levels in almost all Member States, with the Portuguese 10-year sovereign yield being similar to the 10-year sovereign yields of the US or the UK. This may eventually distort investors’ incentives to hold Portuguese bonds and may undermine the ability to raise additional capital.

By now, the most relevant feature in sovereign bond markets should probably not be nominal yields. By 21 April 2015, the difference between the Portuguese and the German 10-year sovereign yields was nearly 200 basis points, eight times higher than in 2008. These spreads are passed on to the real economy and widen the gap between Member States. Moreover, even though ECB and IMF officials have been downplaying the consequences, in terms of contagion, of a rupture between Greece and its EZ partners, the potential repercussions of such a rupture on countries like Portugal are an important risk factor.

With regard to funds and investment management, 2014 was marked by the winding up of Banco Espírito Santo (BES), and the inevitable consequences that affected the several branches of the financial group. Regarding the asset management companies connected to BES, the loss of investors was unavoidable but no relevant evidence of a flight-to-safety abroad has been recorded in the aftermath of the winding up. The most probable scenario was that assets ended up being channelled to competitor banks’ investment instruments.

Evidence of significant co-movement among mutual fund investors was found in Portugal, as well as of flight-to-quality. Recent market developments suggest that investor confidence in mutual funds is back on the path to recovery and that mutual fund investors are more willing to invest in riskier fund categories.

The most recent figures on the relative weight of market platforms reveal a comeback of lit markets. Venue fragmentation and trading dispersion still persist, however, posing a challenge to market oversight.

Looking ahead, the extent of the effectiveness of ECB’s attempts to revive its transmission mechanisms to financially support the real economy and bring inflation closer to the monetary policy
target will determine the outlook for numerous economies in the upcoming months. The dual goal of strengthening bank capital and deleveraging the most indebted banks, along with the need to fuel credit to the real economy, has proven hard to attain.

One additional note of concern relates to the profitability of the banking sector, which remains an important threat to financial and economic stability in Europe. The upcoming months should also bring developments in the discussion of institutional reform in the EZ and in the EU as a whole.

Lastly, the increasing importance of capital markets reinforces interdependence between international financial institutions. The competent supervision authorities from different jurisdictions are urged to work in close cooperation and establish a comprehensive framework to avoid regulatory arbitrage, and to detect and curb systemic risks in useful time.
2. Macroeconomic Report

“Financial markets may be mispricing risk. There is evidence that markets are repeating behaviours that led to the financial crisis in 2007”.

OECD, Interim Economic Assessment, 18 March 2015

The recent macroeconomic background promoted a bolder monetary policy in Europe:

In early May 2015, several macroeconomic, political and social indicators for the Eurozone (EZ) syndicate both the optimistic and the pessimistic outlook for the remainder of the year. As in several occasions during the last year and a half, yet again the prospect of economy picking up has some traction in the data but, like then, important caveats must be recognised.

At the end of 2014, and by the time a bolder intervention from the ECB became more and more probable, the macroeconomic scenario was one of increasing concern. After a relatively long period of low volatility in most markets, accompanied by moderate economic optimism in some distressed economies, economic expectations and market behaviour shifted significantly from late September onwards, reviving some (not so) old doubts and questions. The IMF revised downward its macroeconomic prospects for global growth for 2014 and 2015, with a particularly gloomier outlook for the EZ. By the end of 2014, the real economic data for Germany and most EZ economies proved to be below expectations, contrasting with better economic indicators for the US and the UK. Altogether, the probability of a triple dip recession, with the impending threat of a Japan 1990’s-like evolution in the EZ was gaining momentum. Combined with geopolitical distress in some critical regions of the world (from Ukraine and Africa to Syria and Iraq), conditions for turmoil were in place in several markets.

Meanwhile, public dissent was noticed, most notoriously in France, Italy and Germany, regarding the flexibilisation of the EZ’s national budget goals. The Eurogroup did not allow Greece to leave the Economic Adjustment Programme ahead of schedule and sovereign yields in countries like Greece, Spain and Italy soared, as they also did in Portugal. In Portugal, five days after the 10-year sovereign yields broke below 3% (a historically low figure in nominal terms at the time), yields went up again by about 25%, reminding markets that the previous calmness could be disrupted very rapidly. In the beginning of 2014Q4, most of the stock exchange gains of the year had been erased in several markets, a situation that not all markets

1 Quantitative data available until 22 April 2015 is used and depicted. Some inputs are considered until early May 2015.

2 Referring to the economic stagnation with the low inflation/deflation period that crippled the Japanese economy, mainly, in the 1990’s.
proved to be able to revert until the end of the year. Furthermore, unsatisfactory results from the second Targeted Longer-Term Refinancing Operations (TLTRO)\(^3\) held by the ECB became evident by late December. The TLTRO was intended to free European banks and NFC from a considerable fraction of their more illiquid and probably low-quality assets, aiming at creating more favourable conditions to boost lending to the real economy.

In a nutshell, by the end of 2014, along with the problems stemming from Greece’s sovereign debt management, flight-to-safety movements were identified, with more investors turning to the US, German and also French and AAA sovereign treasuries and bonds. There were also doubts over the actual end of the euro crisis that had been announced by prominent European political leaders.

**The first months of the full deployment of Quantitative Easing in Europe:**

In early 2015, the ECB’s assessment of the EZ remained cautious. The risk of low inflation in the medium term led the ECB Governing Council to announce additional non-standard monetary measures in January, despite the lack of unanimity, with some members advocating a “wait and see” option. The **ECB finally promised to deploy a €60 billion per month Quantitative Easing (QE) plan** for the next couple of years, aiming at private and public debt. This QE\(^4\) initiative was announced to start in the beginning of March 2015.

Oil prices continued a downward trend in the first months of 2015, with Brent’s price dropping more than 50% in one year, only to slightly rebound, hovering about a loss of 40% by early May. The euro depreciated against the dollar by about 20% in one year (early May data). The external trade balance in the EZ maintained a clear and stable surplus and the GDP managed to return to positive growth in 2014 (0.9%). The stock market bloomed in the first four months of 2015, with at least a seven year record high, when considering the 300 largest European companies. Sovereign yields fell to nominal all-time lows in more than 20 European countries.

In March, the ECB revised the economic outlook for the EZ with optimism, in line with the European Commission’s forecasts. Despite the high level of uncertainty, macroeconomic prospects and credit activity seem to respond positively to the non-standard policies announced in January. With the new asset purchase programme, the ECB is reducing banks’ funding costs, aiming at bring down borrowing costs for businesses and households.

By early May 2015, despite the risk of underestimating the threat of contagion of an EZ break up caused by the political and financial crisis downward trend it was in (due to a higher pace of loan repayments from European banks owing to the ECB).

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\(^3\) Only by January 2015 and after several months of TLTRO and direct purchases in the European covered bond and asset backed securities markets, the ECB balance sheet reverted from the

\(^4\) Further detail on this programme is presented in the Bonds & Derivatives section.
between the EZ and Greece, the institutional consensus on the macroeconomic prospects for the Eurozone are positive. According to the IMF, the recent evolution of external macroeconomic variables sustain an upward revision of the near-term prospects.

**First notes on Portugal:**

Referring to the Portuguese economy, the IMF sustains a more positive approach, precisely quoting the euro-dollar depreciation (at its lowest level in 12 years), the record low sovereign yields (historical minimum) and low oil prices (the lowest since 2009). But the still recent market turmoil of late 2014, highlighted above, exposed the frailty in several markets and economies, most affected by the crisis that started seven years ago. **Confidence in a better outlook for these economies, such as the Portuguese, is not being fully supported by economic fundamentals.** Besides, sovereign debt is still mounting, and the high external debt is yet to show a decent decrease. In fact, Portugal ended 2014 with a positive GDP growth (+0.9%), mainly supported by private consumption, which more than compensated for the negative contribution from external demand. It should be noted that, between

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2013 and 2014, household savings as a percentage of disposable income fell from 8.7% to 6.9% and credit to consumption picked up to reach a four-year high by March 2015. GDP growth was in itself at odds with what would be expected if the Portuguese economy was aligned with its most relevant partners; it compared poorly, for instance, to Spain. Portugal recorded the lowest growth rate of the year in 2014Q4 (0.7%, compared with the previous year). On the contrary, Spain continued to gain momentum, finishing with a 2.0% GDP growth between the final quarters of 2013 and 2014. Moreover, throughout 2014, trade imbalances deepened (fuelled by higher imports due to internal consumption). The first data for 2015 shows a mixed evolution, with the Portuguese goods exports and imports decreasing in January (when compared with the same period of 2014), to recover in the following month. Whereas lower imports can be mostly explained by an abnormal base effect, the uncertainty in goods exports is worrisome. Low oil prices and some geopolitical instability have taken a toll in the consumer drive of the most recent and important buyers, leading to a steep fall in Portuguese exports to several countries. A trend that the Portuguese economy, at least for the time being, has not managed to counterbalance by gaining enough market share elsewhere.

The single most important market contributing to the external trade evolution in Portugal in the first months of 2015 was Angola, stricken by the steep fall in oil prices, its most important source of revenue. Even though the effect on exports to Angola could be somewhat expected, it is troubling to notice that other destinations did not compensate this fall. In fact, Portugal performed badly with its non-EZ partners in early 2015, loosing demand in Angola, Russia, Turkey, Saudi Arabia, USA, China and Algeria. The relatively better performance in the Netherlands and France was too little to balance things out.

The situation has been particularly serious in oil producing countries such as Angola or Brazil. In 2014, Angola was the fourth destination of Portuguese exports and Brazil the eleventh. The economic impact in the Portuguese economy goes beyond a shrinking demand. In recent years, many Portuguese companies directed their main activity towards Angola or Brazil to exploit the potential of those economies and mitigate the impact of weak domestic prospects. This led many Portuguese to migrate to Angola, Mozambique or Brazil. If the prospects are not reverted relatively quickly, the situation can lead to further erosion in SME profitability and a significant return of working age people. With the currently slow pace of net job creation in Portugal, this could create additional stress to the Portuguese social welfare and could hinder the recovery of an already fragile economy. In the case of Angola, the impossibility to repatriate capital, together with the devaluation of the kwanza, are additional sources of concern to Portuguese companies that are highly dependent on the Angolan market.

All these troubling signs come on top of a seven-month downward trend in the economic activity
indicator\textsuperscript{6}, which finally stabilised in February 2015. Moreover, the latest data (February) for the Near Term Production Quantitative Indicators reveal negative signs in the industry, construction and services sectors. On a brighter note, the Near Term Qualitative Indicators continued to exhibit an upward trend, in spite of the abrupt fall in the Consumer Confidence Index (April 2015). Conversely, the beginning of 2015 brought a significant decrease in the investment intentions stated by Portuguese companies, compared with what they reported in mid-2014 (a decrease in combined investment intentions of \(-2.2\%\), against the 1.1\% increase reported earlier).\textsuperscript{7}

For Portuguese CEOs, the lack of demand continues to be the single most important difficulty. The threat of diminishing profitability also seems to be dampening investment prospects. Note that managers are increasingly using their companies’ own resources to support the intended investment, and resorting less to banking credit.

On a brighter note, positive labour market expectations do exist, in line with one of the improving indicators for the Portuguese economy in 2014: a decline of the unemployment rate to 13.7\% in 2015Q1. This decline was made possible by an actual increase in the number of jobs available, by the still enduring emigration flow, but also by the success of public policies actively boosting temporary jobs (internships and apprenticeships).

Are the first 2015 external trade results to be confirmed? Will exports regain momentum as the European Commission predicts in its spring economic forecasts? And to what extent is the huge decrease in investment that marked the Portuguese economy since the 2008 crisis to blame for a seemingly sluggish recovery when compared with some of Portugal’s most significant economic partners? According to the IMF, the potential growth of the Portuguese economy should hover around 1.25\% in the upcoming years, due to low investment, considered insufficient to revert the effects of the accumulated capital decrease of prior years. Data from the European Commission also show that, in 2014, the Portuguese stock of capital per employee was just about half the EZ average, comparing poorly to Greece, Spain, Ireland and Italy.

These are some of the questions to follow in the upcoming months and whose answers will determine the seriousness of the hardship and vulnerability of the Portuguese economy, for instance, in the event of a change of cycle in the global economy. For the time being, the Portuguese economy seems to be dragging along, unable to fully take advantage of the low oil price/low euro combination.

Some further insights on economic prospects:

The last time the expectation of a reinvigorated economic growth had to be revised can be traced

\textsuperscript{6} Computed by Statistics Portugal.

\textsuperscript{7} Statistics Portugal, Investment Survey, January 2015.
back to the World Economic Outlook (WEO) of October 2014, when the global macroeconomic outlook for the coming months and years became less optimistic (the IMF revised downwards the 2014 and 2015 global growth rates). On their part, the IMF dedicated some attention to the hypothesis of a Secular Stagnation Scenario. This Secular Stagnation Scenario speaks volumes on the worrisome consequences that a low-growth, low-inflation environment could potentially have and, if this scenario should materialise, it could affect developed economies in a most significant way. The latest WEO (April 2015) reveals a slightly more optimistic but still prudent IMF\(^8\): “(...) The distribution of risks to near-term global growth has become more balanced in relation to October 2014, but is still tilted to the downside. (...)”. For the IMF, macroeconomic prospects are not consistent across the world: positive recovery signs in advanced economies but economic decline in emerging economies. The forecasts point to an increasing discrepancy between the two sides of the Atlantic: a 3.5% growth rate in the US, against 1.1% in Europe. 

The European and the Japanese economies risk experiencing a period of economic stagnation.

The IMF recommends accommodative monetary policies, complemented with structural reforms and better fiscal frameworks, in order to pick up growth and reverse the poor investment climate in those regions. Moreover, economic developments in emerging economies are not promising and are driven by low growth and commodity prices. The net effect of commodity prices on commodity-importing countries is not clear and will probably depend on the magnitude of the dollar appreciation and on the evolution of commodity prices, as those two elements can cancel each other out. Furthermore, government consolidated gross debt as a percentage of the GDP in Portugal has risen in recent years, increasing 34.0 percentage points between 2010 and 2014. For the EU-28, the change equals 8.6 percentage points, on average. In 2014, government consolidated gross debt represented 130.2% of the Portuguese GDP, against an average of 86.8% for EU countries.

\(^8\) In line with the latest OECD Interim Economic Assessment, consulted on 18 March 2015 at
http://www.oecd.org/eco/outlook/economicoutlook.htm
Graph 3 – Differences in the latest consecutive GDP forecasts for selected Countries


Graph 4 – GDP at market prices (2005=100)

Source: Eurostat.

Graph 5 – Government Consolidated Gross Debt as a Percentage of the GDP

Source: Eurostat.

Graph 6 – Per Capita GDP at market prices (€)

Source: Eurostat.
Following these insights, it may be fruitful to analyse how the *per capita* GDP evolved in recent years. In Portugal, *per capita* GDP at market prices exhibits a negative trend between 2010 and 2012. More importantly, Portugal has been diverging from its EZ peers: in 2009 the *per capita* GDP of Portugal was 60% above the EZ's *per capita* GDP, having declined to 56% in 2013/2014.

According to the latest data on non-performing loans, both non-financial corporations (March 2015) and households (December 2014) continue to beat previous all-time highs in Portugal, albeit with lower increments among the NFC. The analysis of the different categories of Portuguese NFCs with overdue loans is also revealing. Considering both the difference between the biggest (above €5 million) and the lowest (below €20 thousand), and the difference between the second highest (€1 million to €5 million) and the second lowest (€20 thousand to €50 thousand) loan percentage intervals, the bigger the loan, the higher the number of non-performing contracts. This is a worrisome indication of the health of the Portuguese economy. In 2014, some signs of performance gap improvement among the most extreme cohorts is countered by an increased degradation in the quality of loans ranging from €1 million to €5 million. Even though not shown in the depicted time series, this recent evolution – since the end of 2013Q1 - comes more from lower creditworthiness among NFCs that took large loans than from a significant improvement among small borrowers.
The global level of new loans has been erratic, with no clear trend in the last couple of years but at a lower level than before the crisis. Nominal interest rates, on the other hand, have now returned to pre-crisis levels or even lower: in a smoother way for loans up to €1 million, and with a remarkable move since the second half of 2014 for loans above €1 million.

Considering that non-performing loans are a good proxy for financial distress in the economy, the assorted indicators depict a gloomy scenario. With very few exceptions – Germany is one of the most notorious – credit quality in the EZ has diminished since 2008.

Broadening the scope to all debt issuance, the overall net issuance of debt securities in Portugal has been negative for several quarters, reaching some of the lowest figures of the series during 2014, and the minimum for the issuance of long-term debt securities in 2014Q4. For NFCs, after positive net issuance in 2012 and 2013, 2014 brought a first half of the year with the lowest (negative) figures at least since 2005, with a slight recovery in the latter half of the year.

Graph 9– Gross total doubtful and non-performing loans in the balance sheets of domestic banking groups and stand-alone banks (% of total debt instruments and total loans and advances)

Graph 10– New loans, respective interest

Source: ECB

Source: Banco de Portugal, calculations by CMVM. Note: Latest available data – 28 February 2015.
Graph 11– Net issuance of debt securities – Short- vs Long-term - Portugal

Graph 12– Outstanding amounts of debt securities issued by NFCs - Portugal

Source: Banco de Portugal, calculations by CMVM. Note: Latest available data – 2014Q4.

Graph 13– Net issuance of debt securities by NFCs - Portugal

Graph 14– Net issuance of long-term debt securities by NFCs - Portugal

Source: Banco de Portugal, calculations by CMVM. Note: Latest available data – 2014Q4.
For Portuguese households the credit crunch has been ongoing for more than four years now and the relative weight of mortgage-based loans climbed from 79% in December 2007 to 82% in February 2015. It is among consumer loans and not so much among mortgage-secured credit that non-performing loans have risen the most.

The latest available figures (February 2015) show, nonetheless, a different pace in the still negative rate of change in credit granted to Portuguese households, possibly hinting at a change in the trend. In late 2014, and for the first time in several years, there was a positive change in consumer credit. An occurrence that, for the time being, was not repeated in 2015, although the negative rate of change remains much smaller than in the period 2010 – 2013.

With the exception of 2014, consumer credit for EZ households shows a reduction in the pace of contraction. In Portugal, the overall outstanding loans for households has decreased by 13.0% since its peak in late 2010, while it increased by 0.9% in the EZ during the same period.

Looking at the latest indebtedness data of private corporations and individuals and considering not only loans but also debt securities (nominal value) and trade credits, the deleveraging process shows significant results. There has been a slow but stable reduction in the families’ indebtedness level. In fact, the indebtedness ratio is the lowest (85.4% of GDP) in the last known observation, in December 2014 – lower than by December 2007. In the case of private corporations, the last seven quarters contributed decisively to move away from the peak (162.5% of GDP) recorded in March 2013, but by December 2014 (141.8% of GDP) it is still higher than during the 2007-2010 period.

Graph 15– Change in credit extended to households in Portugal and the Eurozone (mortgage and consumer credit) - %

Source: ECB

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9 The scope goes beyond households. It also considers self-employed entrepreneurs and non-profit institutions serving households.
Taking a closer look at private corporations by size of workforce and non-financial holdings, only micro-, small- and medium-sized enterprises (SME) are now clearly below the respective indebtedness level of late 2007. The indebtedness of large corporations (until September 2013) and non-financial holdings (until March 2014) continued to increase. In December 2014 and after about one year of deleveraging, the indebtedness of large corporations increased once again.

It should be stressed that according to an analysis by Banco de Portugal of data that comprises the years 2011, 2012 and 2013, most of the deleveraging among private corporations occurred in the context of debt write-offs resulting from bankruptcies (particularly in the real estate and construction sectors) and only a minor fraction comes from actual deleveraging of enduring companies. A situation that Banco de Portugal expects will endure in the coming years.

If the debt level is correctly identified as an obstacle to the development of Portuguese private corporations and the overall growth prospects of the economy, the bulk of the data presented here shows that this problem is on its way to be solved. But this could be a very simplistic way to look at these figures. As already shown, the new loans contracted with the

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**Graph 16– Private Sector Indebtedness (% real GDP)**

Source: Banco de Portugal, calculations by CMVM. Note: Latest available data – 2014Q4.

**Graph 17– Indebtedness of Private Corporations by Size of the Corporation and Non-financial holdings (% of real GDP)**

Source: Banco de Portugal, calculations by CMVM. Note: Latest available data – 2014Q4.

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10 This data includes non-financial holdings in order to account for the total debt of private corporations.

11 In Boletim Económico, May 2015.
banking system have been slowly decreasing, although with high volatility, mainly loans above €1 million. Thus, the higher indebtedness, mainly among large corporations and non-financial holdings, even with GDP growing again, could only be explained by the rise of debt securities and trade credits. But, as stated, this is not necessarily happening with micro- and small-sized enterprises. The conclusion of a still fragmented access to capital markets is strengthened by the sustained - if not increasing - small versus large loan interest rate spread and the absence of SMEs from stock markets.

Nevertheless, for Portuguese CEOs, access to new capital or liquidity is not one of the main obstacles to business. Time and again, data from Statistics Portugal (INE)’s Investment Survey has identified lack of demand as the main difficulty for business development in Portugal, as previously stated in this report.

On the other hand, a progressive phasing out from debt to self-financing is shown when the CEOs are enquired on the sources of financing. Moreover, even though nominal interest rates have been clearly decreasing, the real cost of money has been increasing.

In part, the nominal price fall is explained by a reduction in transportation costs (lower oil prices), but core inflation has also been diminishing. This could lower the probability of prior viable businesses to endure and can, in the near- to medium-term, pose significant solvency risks. In the end, the soundness of the lasting debt among private corporations will depend on the soundness of the investments and on the fundamentals of the economy.

In the meanwhile, the ECB took bolder monetary policy decisions as a reaction to the feeble aggregate demand of the EZ and to the successive decrease in inflation departing further and further away from ECB’s price stability goal (i.e. EZ inflation hovering around 2%). The full blown QE that the ECB has been deploying since the beginning of March came after a period when seemingly all the liquidity that the ECB injected was insufficient to budge the velocity of money, at least in the intended direction. Nevertheless, the still recent QE could have changed the picture on this subject.

Adding up to the still existing inflation differences that create a considerably more challenging background for corporations looking to thrive in Portugal (when compared to the ones in Germany), there is still a price depression slowly but steadily spreading across the EZ countries. The mere announcement of the QE programme (in January 2015) could have played a role in the recent increase in the Harmonized Index of Consumer Prices (HICP).

The real estate market has been one of the focal points for risk transmission across multiple sectors. From the US-born sub-prime crisis to the latter bubbles in Spain and UK, weariness over real estate has increased, making it a crucial area of financial stability analysis. Currently, China is probably the most real estate bubble-prone economy, but Brazil, the Netherlands and some
regions of the UK are frequently under the radar for new bubble identification. In Portugal, no actual bubble burst occurred in the aftermath of the financial crisis but real estate investors took an unavoidable toll. The housing market contracted at least since the beginning of 2010 until the end of 2013Q1.

The high real estate market illiquidity, combined with non-performing loans put banks under stress and brought about potential conflicts of interest in highly verticalised financial groups with stakes in insurance, mutual funds and asset management, and even regulatory arbitrage. This has been one of the action matters for the Portuguese tri-party financial supervision authorities over the last few years.

The current data on the real estate market shows a pickup in the number of houses sold and more significantly in prices. Nonetheless, the increase in prices (more notorious in regions with more tourist appeal such as Lisbon and the Algarve) has been barely accompanied by real estate banking appraisal values, which signals that banks are still prudent and probably not so important as market players as they were in the past. The Portuguese real estate market had a revival during 2014, mainly in the high-end housing market. Commercial renting also shows good signs, especially in Lisbon. For the resurgence of the high-end housing market, which is boosting the whole market, a mix of new sources of demand (from China and France, mainly due to the Golden Visa Programme\(^\text{12}\)), but also a return of Portuguese investors to the market are seldom quoted as main drivers. According to some recent statements by real estate agents from the biggest firms operating in the Portuguese market, local investors could be fleeing from financial markets due to both a lack of trust and lower yields.

To what extent will this movement continue to drive the market? To what extent will prices pick up in other segments? How will this movement affect (positively or negatively) other sectors via capital flows? For the time being, in the aftermath of a couple of very harsh years for all market players, a moderate increase in prices and sales contributes to lowering the riskiness coming from this market and to mitigate some of the still ongoing distress. Nevertheless, under an environment of increasing liquidity provisioning to financial markets and under a global movement of search-for-yield, the real estate market should be kept under close surveillance, both domestically and internationally.

\(^{12}\) The Portuguese government put in place a programme where it exchanges a resident permit for a €500,000 investment in the country (frequently done via real estate investments).
Graph 18 – Velocity of Money in the Eurozone

Source: ECB, Eurostat, calculations by CMVM.
Note: Latest available data – 2014Q4

Graph 19 – Spread between 12-month Euribor and Harmonised Index Consumer Prices (HICP) - Portugal and Germany (percentage points)

Source: Bloomberg, Calculations by CMVM.
Note: Latest available data – 31 March 2015

Graph 20 – HICP – Selected countries and Eurozone (percent change)

Source: Bloomberg, Calculations by CMVM. Note: Latest available data – 31 March 2015

Graph 21 – Number of Houses Sold

Source: Bloomberg, Calculations by CMVM. Note: Latest available data – 31 December 2014.
Looming and latent risks from a macroeconomic perspective

To better put in perspective the current levels of interest rates, sovereign yields and asymmetries between the European Union and the EZ countries, a group of additional indicators is considered and computed. To begin with, the frequently quoted sentence that the EZ is recording historically low interest rates and, more generally, a historically low price of money must be taken with caution. ECB reference rates, Euribor and even sovereign yields are nominally at or close to minimum historical values, but a different picture emerges when inflation is discounted. The HICP also records the lowest values in several countries, with outright negative price changes occurring in Portugal, Spain and Greece, among other countries.

Furthermore, several competing investment options record historical minimums, but this says little of the evolution of their relative attractiveness from the point of view of yield seeking investors. For instance, even though the 10-year sovereign yields in Portugal have been at the lowest nominal value in history, the 12-month Euribor spread (a usual reference for return on savings deposits) makes sovereign yields – ceteris paribus – much more attractive now than before 2009.
Additionally, when sticking to comparing the same class of investments, the yield spread (vis-à-vis Germany) of Portuguese 10-year sovereign bonds is still clearly above its level prior to the financial crisis or even after. This happens both when considering nominal and real data (discounted by each country’s HICP). For sovereigns, the real interest rate that each country has to pay reveals a scenario that is far from the pre-crisis level. The nominal and the real effort to sustain each euro of old or new debt has diminished for most of the EZ countries since the crisis highs but it has not collapsed to historical lows as an untrained eye would state while looking only at nominal yields.

The fragmentation of the sovereign market becomes quite evident when comparing sovereign yield spreads. Entering a protracted low inflation period could erode sovereigns’ ability to maintain the fiscal revenue at the levels required to service the debt and could undermine the capacity to decrease spending without triggering a deflation spiral.

On the other hand, the reasons for the actual decrease in real yields and spreads could reveal an additional problem given that macroeconomic fundamentals have not vigorously improved. The external and sovereign debts have but increased in the last years in countries like Portugal and the prospects for economic growth are feeble.

Graph 24 – Spread between Portuguese 10-year sovereign bond yields and 12-Month Euribor (percentage points)

Source: Bloomberg, calculations by CMVM. Note: Latest available data – 31 March 2015
Graph 25–Nominal Bond Yields (10-year government bond yield) – Percentage Points

Graph 26– Spread Towards German 10-Year Bond Yield – in Nominal Terms – Percentage Points

Source: Bloomberg, calculations by CMVM. Note: Latest available data – 28 February 2015

Graph 27–Real Bond Yields (10-year government bond yield minus HICP inflation rate) – Percentage Points

Graph 28– Spread Towards German 10-Year Bond Yield – in Real Terms – Percentage Points

Source: Bloomberg, calculations by CMVM. Note: Latest available data – 28 February 2015
The additional yield that sovereigns still pay when compared to lower risk, investments within the EZ and across the globe, along with a global shortfall of secure assets (like US and German sovereign debt), could have been spiking “high yield” sovereign bond demand, thus lowering yields for riskier sovereign debt, creating a market driven in a manner not far from the workings of a junk bond market. This apparently increasing global search for yield could be hampering risk assessment and sound price formation, and in the event of an unexpected exogenous shock, it could lead to the unfolding of a systemic event.

Against this background, monetary policy instruments intended to fight deflation risks could turn out to be themselves a risk factor. In other words, if not carefully envisaged and articulated with complementary policy actions that prove to be clearly effective in fuelling sound economic investments and the indispensable demand, monetary policies could be a risk factor. Achieving real economy yields, which divert investments from search-for-yield and bubble-prone markets seems to be critical at this point.

The subject of euro sustainability and resilience recently appeared in the public agenda again, to be quickly rebuffed by declarations of complete commitment from ECB officials. The economic fundamentals portrayed here and the remainder non-economic background recommend that this risk is not neglected but instead considered one of the most serious in consequences and with moderate probability of occurrence. The expectations of a protracted period of low or negative inflation combined with low growth, austerity weariness in most of the EZ countries and important political dissent within the EZ could put at risk not only the external debt sustainability in several countries but also the very integrity of the EZ.

Worldwide, there have been lower inflation tensions, with some research centres stating that overall inflation in 2014 should have decreased to somewhat short of 4%. Not surprisingly, with global economic growth not accelerating significantly over the last 12 months (data from mid-April 2014 until mid-April 2015) commodity prices have decreased (zinc is an exception).

At the same time, the co-movement of the returns of a series of different financial instruments has changed considerably over recent years, meaning that contagion risk or/and interconnectedness haven’t had constant intensity. The variance explained by the first principal component increased in 2014 and the first two months of 2015, signalling a potential increase in contagion risk.\(^{13}\) The increasing financial integration of public and private debt markets around the world might be a plausible

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\(^{13}\) This composite indicator aggregates data from 23 different series (DAX, Jones Industrial, Euro Stoxx 50, FTSE 100, Nasdaq 100, Russell 2000, S&P 500, Germany 10-year sovereign bonds, France 10-year sovereign bonds, UK 10-year sovereign bonds, USA 10-year sovereign bonds, AAA Sovereign Debt, BBB Private debt, EUR/CHF, EUR/GBP,EUR/JPY, EUR/USD, VIX and prices of gold, silver, oil, wheat and natural gas).
explanation for such co-movement.

The simple correlation between equity and commodities is at a lower level than in the most troublesome period of 2008-2012. Yet, the beginning of 2015 shows a consistent conjoint behaviour in both markets. The relatively low correlation, however, should prevent any dramatic conclusions.

Another looming risk that should be stressed at this point comes from market-based financing. It has been signalled as a significant risk, namely in China and in the USA, and it is being tracked with increasing interest in Europe. The European Union recognises the importance of these activities and, together with the G-20, is committed to developing proper mechanisms to increase data accuracy, improve transparency, and promote a better identification and mitigation of risks and vulnerabilities of non-bank activities. The European Commission has recently presented legislative proposals on money market funds and on reporting and transparency of securities financing transactions.

In addition, the European Commission has put forward a plan to build a Capital Markets Union, aiming at strengthening the internal market of financial services, diversifying funding sources and mitigating the effects of the banking crisis on taxpayers. However, in its current version, it is strikingly omission (for instance, it fails to address fiscal terms), which advises moderate enthusiasm regarding its effectiveness.

Graph 29 – Commodities (Price indices in USD; 100 = Jan2009)

Source: Bloomberg, calculations by CMVM. Note: Latest available data – 21 April 2015

Graph 30 – Co-movement of Sovereign and Private Debt Yields, Stocks, Forex and Commodity Indexes

Source: Bloomberg, calculations by CMVM. Note: Latest available data – 28 February 2015

The latest (April 2015) PMI indexes from Markit
reveal unexpected underperformance by European economies, hinting that the probable higher GDP growth rate in 2015Q1 may not be sustained in 2015Q2. These figures give some substance to the questions on the limits of the current growth rate cycle in developed economies. A question that resonates with the most recent advice from several international financial institutions on the need for a comprehensive policy approach to the economy, given the existing evidence that markets are repeating behaviours that led to the last financial crisis. Overall, high demand for AAA sovereign debt subsists across the globe, along with search-for-yield strategies and an increase in cash hoarding by the richest investors. This triad does not represent a significant difference from the one witnessed one year ago. Like then, it represents a frail background for predicting sustainable and enduring growth and, consequently, for predicting alleviation of overall risk perspectives for the near future.

Graph 31 - Correlation between Equity and

Commodities

Source: Bloomberg, calculations by CMVM. Note: Latest available data – 21 April 2015
3. Securities Markets

Indicators

Equities & Equity Futures – selected indicators

The turmoil that began in mid-October 2014 was prolonged until the end of 2014. By now it looks like a blimp in an exuberant upward trend, more or less common to most of the international stock exchanges. Nikkey, S&P500, ISEQ, Eurostoxx 500 and MSCI World have all recorded the highest levels at least since January 2009 in the most recent weeks. In some cases, even historical record highs have been broken during the first months of 2015. PSI20 exhibited one of the highest returns since the beginning of 2015 (26.6% on 21 April). The slightly better economic prospects could partially justify this, but the ECB’s QE policy along with the still accommodating stance of the monetary policy by the FED and the loose monetary policy in Japan are the prime suspects for boosting the stock exchange markets worldwide in the first four months of 2015. Volatility clearly decreased in the first months of 2015 in almost all financial markets.

Graph 32 – Stock Market Indices

Graph 33– Equity Realised Volatility
By mid-April, VIX recorded the higher value (lower risk) compared to VSTOXX and PSI20 VaR. Throughout April, some increase in volatility and Value-at-Risk in PSI20 could be explained by lingering doubts on the European negotiations on Greece’s additional financial aid and by the potential contagion that an ill outcome could bring, while, in the second half of 2014, the increase was related to the winding up of BES.

If one looks at the relationship between the earnings yield (E/P) of stock indexes and 10-year Treasury bond yields (Y), in the long run, both variables tend to move in the same direction. Intuitively, bonds and stocks compete for investment funds and those funds tend to move towards the more attractive investment.\(^{14}\)

As of May 2015, the difference between the stock market earning yield (E/P) and the 10-year Treasury bond yield (Y) ranges between 3% and 4% in some economic regions, but not in Portugal. This is to say that, according to this model, stocks are cheap, when compared to Treasury bonds. Concurrently, the likelihood of having a bubble burst in the near future is higher for the bond market, as this market appears to be overvalued vis-à-vis the equity market.

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\(^{14}\) Criticism often laid on the Fed model is that it compares a nominal quantity (Y) to a real quantity (E/P).
In the case of Portugal, the indicator has exhibited a large negative value since 2011 but with an upward trend since 2013. Until 2012, this emanated mainly from the large default risk perceived by investors on Portuguese sovereign debt (which continues to present a large spread in comparison to German bonds with the same maturity), but from then on, the comparatively steeper fall in the Portuguese stock market earnings also played a relevant role.

Concerning investor sentiment and stock market activity, the positive sentiment recorded an upward trend since January 2014, while negative sentiment decreased during the first half of the year. In the second semester of 2014, there is an increasing interest for negative search terms, probably due to the news about the Portuguese banking sector. The search for positive terms was again stronger over the first quarter of 2015. Meanwhile, the Economic Sentiment Indicator for the Portuguese economy recorded a seven-year maximum in March. Both measures correlate with aggregate stock market returns. However, the strength of these correlations varies over time. The correlation of stock market returns with the positive sentiment is positive for 75% of the 52-rolling weeks from January 2009 to March 2015, and with the negative sentiment, it is negative for 83% of the 52-rolling weeks under analysis.
Graph 37- CAPE – S&P 500


Graph 38– PSI20 – CAPE and Earnings

Source: Bloomberg, calculations by CMVM. Note: Latest available data – 2014Q4

Graph 39- CAPE – MSCI EMU


Graph 40– Price to Book Ratio - Banks

Source: Bloomberg, calculations by CMVM.
The Cyclically-Adjusted Price-Earnings Ratio (CAPE) of S&P500 is very close to its 15-year historical average at the end of 2014, while, in the case of MSCI EMU, it also deviates slightly from the 10-year historical average. Nevertheless, using state space models (not depicted) or a lengthier historical average, we witness above average CAPE. Regarding Portugal, CAPE is below 14 at the end of 2014, which contrasts with the 18.7 observed for 2014Q1. This evolution may be justified by the extraordinary events that affected two relevant PSI20 firms: the bankruptcy of Banco Espírito Santo, and important losses in short-term investments of Portugal Telecom in Grupo Espírito Santo commercial paper. The structural earnings of Portuguese firms dropped by more than 20% between 2011 and 2014.

Similarly to European and US banks, the price to book ratio of Portuguese banks has decreased since the beginning of the century. However, after the European sovereign debt crisis, the Portuguese financial institutions have revealed higher financial stress, probably due to higher negative forward looking investor confidence.

Analysing the weight of the net present value of growth opportunities (NPVGO) on stock prices of

Graph 41– Net Present Value of Growth Opportunities

Graph 42– PSI20 monthly average dividend yield

15 A difference that, for the Eurozone, is amplified when using the alternative approach, which relies on an unobserved component model specification to disentangle the trend and the cycle components from the series of earnings.

16 NPVGO is calculated considering 12 firms quoted in Euronext Lisbon. Stock prices, earnings per share and cost of capital are value-weighted. $P_0 = \frac{EPS_1}{\tau_0} + NPVGO_0$, where $P_0$ is the stock price on period 0, $EPS_1$ are the earnings per share on period 1, $\tau_0$ is the cost of capital of firms on moment 0 (assumed constant and equal to 8.5%) and $NPVGO_0$ is the net present value of growth opportunities on period 0.
Portuguese firms, a positive trend is apparent, suggesting that investors are putting more emphasis on the future growth opportunities and dividends. It is yet to be determined if the behaviour in the second half of 2014 is a mere blimp or a reversion of the trend.

The monthly average dividend yield of PSI20 stocks stood near 3.7% from the beginning of 1999 to April 2015, with a positive trend, almost mirroring the evolution of PSI20. After its peak in 2011 (and coinciding with low GDP growth rates), the dividend yield has stayed below the average for most of 2014, again suggesting expectations of higher growth opportunities and dividends in the future. On the other hand, the average implied risk premium in the Portuguese market stood at around 8.4% between 1999 and 2014. From 2000 to 2014 the Portuguese PSI20 presents an annual average return of -2.60%.

The Portuguese version of CISS (Composite Indicator of Systemic Stress) reached a maximum in 2009, following the subprime crises that ultimately led to the collapse of Lehman Brothers. The indicator also captures risk events as financial stress following the political crisis (summer of 2013). Moreover, it also reveals the implications arising from the recapitalisation of Portuguese banks (2012) and the winding up of BES and the short-term investments of Portugal Telecom in Grupo Espírito Santo commercial paper (2014). These recent events explain the different CISS evolution in Portugal, when compared to the EZ.

![Graph 43– Average implied risk premium - Portuguese Markets](image)

17 The implied market return was obtained considering a diversified stock portfolio and the dividend discount model, weighted by stock market capitalisation. We consider 5Yr Euro Generic Govt Index to be risk-free.

18 CISS is the weighted average of five sub-indices, calculated based on the portfolio theory approach (where the sub-indices aggregation reflects their time-varying cross-correlation structure) and is available on a weekly basis; each sub-index comprises three stress indicators, normalised based on their recursive sample CDF. Foreign exchange market (FEM) Indicators: realised volatility of the euro exchange rate vis-à-vis the US dollar and the British pound, maximum cumulated index losses over a moving 2-year window (CMAX) of the Portuguese nominal effective harmonised index. Equity Market (EM) Indicators: CMAX, realised volatility, difference between CMAX for Portugal and Germany. Money Market (MM) Indicators: realised volatility of the 3-month Euribor rate, interest rate spread between 3-month Euribor and the average of 3-month French and German T-bills; spread between 3-month Euribor and the OIS rate; Bond Market (BM) Indices: realised volatility of the Portuguese 10-year government yields, yield spread between 10-year Portuguese and German government yields, yield spread between Iboxx corporate and German government yields. Financial Intermediaries (FI) Indices: Realised volatility PSI Financials, CMAX and Illiquidity Index (turnover data). Correlation pairs are computed as exponentially-weighted moving averages (EWMA) with a smoothing parameter of 0.93.
CISS is at a low level (around 0.1) during the first semester of 2014 and then exhibits an upward trend until February 2015, meaning that the level of systemic stress in the Portuguese financial system has increased in recent months. The increasing level of systemic stress during this period comes mainly from the financial intermediaries segment and from the equity market. However, the cross-correlation component reveals a relative divergence of some of the segments, an evolution which is in line with more tranquil periods.

**Bonds & Credit Derivatives**

In the aftermath of the financial crisis that eventually led to the sovereign debt crisis, a bust and boom cycle seems apparent in the sovereign debt yield of countries like Portugal. Especially since mid-2010, the 10-year sovereign yields soared and peaked in mid-2012, only to begin a clear descent path that brought yields close to or even below pre-crisis figures.

The still weak economic prospects and steady declines in prices raised concerns among Central Banks. The Bank of England, the Bank of Japan, the US Federal Reserve and more recently the ECB
engaged in accommodative monetary policies. Quantitative easing programmes, in particular, exert a downward pressure on bond yields. **Threats of long periods of deflation led the ECB to massively purchase sovereign bonds in the secondary market.** Sovereign bond yields in the EZ are being pushed close to zero, reaching minimum nominal historical levels in almost all member states. In early May 2015, both 2- and 5-year Germany sovereign bonds recorded negative yields. On 21 April, the yield on 10-year Portuguese sovereign bonds was below 2%.

The ECB purchase programme is contributing to lower bond profitability, compromising the sovereign bond’s role as government credit instruments: **Portuguese 10-year sovereign bond yields are similar to the 10-year US or UK sovereign bond yields.** This can eventually distort investors’ incentives to acquire Portuguese bonds and undermine the country’s ability to raise additional capital. The evolution of sovereign bond yields in the EZ is being closely followed by several market analysts as the ultimate proof of the success or failure of the QE.
Graph 45- 10-Year Sovereign Debt Yields

Graph 46- 10-Year Sovereign Debt Yields - Other Countries

Graph 47- Spread between 10-year and 2-year Sovereign bond yields

Graph 48- Portuguese sovereign debt yield curve

Source: Bloomberg, calculations by CMVM. Note: Latest available data – 21 April 2015.
**ECB - Nonstandard Monetary policy**

The risk of low inflation in the medium term led the ECB Governing Council to announce additional non-standard monetary measures in January 2015. The asset purchase programme was extended to include the Public Sector Purchase Programme (PSPP), supplementing the Asset Backed Securities and the third Covered Bond Purchase program, launched in September 2014.

The Expanded Asset Purchase Programme (APP) has a monthly target of €60 billion from March 2015 until, at least, September 2016. The new PSPP is conducted by the ECB and national central banks (NCBs) and is directed towards the purchase of euro denominated bonds issued by (i) Governments and national agencies in the EZ and (ii) from a list of international and supranational institutions.

The eligible criteria of PSPP establishes that marketable debt instruments must have a remaining maturity of two to 30 years, with an issue share and issuer limit of 25% and 33%, respectively. In addition, bond purchases have to respect ECB’s capital key on a monthly basis. While the ECB cannot buy debt instruments of supranational institutions, NCBs are only allowed to buy public sector bonds from their jurisdiction.

The purchase of supranational debt instruments is conducted by Banco de España and Banque de France; unless there is an insufficient amount of bonds issued under the NCBs’ jurisdiction. In this situation, NCBs are allowed to purchase supranational bonds. The total purchase of supranational debt under PSPP has a ceiling of 12%.

The PSPP will have a risk sharing of 20%: 8% of the additional purchase made by the ECB and 12% made by the NCB.

It is possible to buy bonds at a negative yield maturity if it is above the deposited rate facility: at -0.2% since September 2014.

On April 13, German 10-year bond yields traded at 0.16% while both the two-year and five-year recorded negative yields (-0.28% and -0.13% respectively). Regarding the monthly asset purchase objective, it is a matter of time before German 10-year yields drop below zero or, in the worst case scenario, below -0.2%. In the latter German bonds would no longer be eligible under the APP. This could jeopardise the effectiveness of the programme and lately compromise the ECB’s primary objective. Public sector bond purchases are limited by the ECB’s capital key, where Germany accounts for 25%, and by the purchase ceiling for supranational bonds.
Eventually, a substantial amount of the monthly €60 billion is at risk of not being invested unless the ECB revises the PSPP criteria. Although there might be a shortage of safe trading assets, negative yields reveal a certain aversion to risk and a lack of confidence in the market. Agents seem to prefer costly assets (in practice, negative yields are perceived as a tax or cost for the investor) rather than holding profitable but risky

For the time being, the spread of 10-year sovereign yields between EZ member states is narrowed. Financial market fragmentation in the last two years has shrunk but it did not return to pre-crisis levels. On 21 April 2015, the difference between the Portuguese and German 10-year sovereign yields was nearly 200 basis points, eight times higher than in 2008. These spreads are passed on to the real economy and widen the gap between Member States. As a result, Portuguese companies currently face higher borrowing costs than in 2008, in relation to their German competitors. Different obstacles to credit access hinder competitiveness and harm efforts to regain market attractiveness.

Over the past few years, the Portuguese sovereign yield curve has experienced a parallel downward shift and the slope became steeper. This is also the case for other European member states. But the spread between 10-year and 2-year bond yields is today much more pronounced in Portugal than in any
other member state (except for Greece). On 1 January 2008, the said spread for Portugal and Germany was 40 and 34 basis points (bp), respectively; it reached 200 and 37 bp, respectively, on 21 April 2015.

After a highly unstable period, Portuguese sovereign yields are following an adjustment path, but the spreads can also signal different economic prospects for Portugal and Germany. The economic outlook remains fragile, and there are still doubts on the solution to the unsolved Greek sovereign debt problem. Even though ECB and IMF officials have been downplaying the consequences, in terms of contagion, of a rupture between Greece and its EZ partners, the potential repercussions of such a rupture on countries like Portugal are an important risk factor.

CDS spreads did not fall with the magnitude of the sovereign yields, at least for Portugal. By the end of March 2015, the spread of Portugal vis-à-vis Germany was 3.6 times higher than in March 2008 (111.48 bp on 31 March 2015). Different risk premiums between member states is now more evident than before the financial crisis.

Sovereign debt of the most fragile EZ economies has been spiking investors’ interest, but the search for yield is also directed towards private debt. According to Dealogic data, high yield bond issuance has been increasing, with issuances from the USA and Europe significantly above 2009 levels. In 2014Q2, European high yield bond issuance has outpaced the American one.

Even though the analysis focuses on high yield issuers\(^{19}\) (with rating equal to or lower than BB+) it is possible that, during the period under review, substantial changes have occurred in the universe of eligible bonds. Issuance volumes are probably moving from investment-grade companies to (high yield) companies that have been recently downgraded. In 2014Q4, machinery, telecommunications and cars/trucks were the leading industries in high yield issuance in European developed markets.

\(^{19}\) Sovereign debt is not included.
**Investment Management**

The year 2014 was marked by the Winding up of Banco Espírito Santo (BES) and the inevitable consequences that affected the several branches of the financial group. *With regard to the Asset Management companies connected to BES, the loss of investors was unavoidable, but no relevant evidence of flight-to-safety abroad was recorded in the aftermath of the winding up*. The most probable scenario was that assets ended up being channelled to investment instruments of competitor banks.

In Portugal, up until March, the year 2015 brought a recovery of Assets Under Management (AuM) of Individual Portfolio Management (+5.0% since December 2014), while Collective Investment stagnated in the same period. AuM of Collective Investment schemes in Transferable Securities (CIS in TS) continued to increase in 2015Q1 (+9.5%), while AuM of Alternative Investment Funds continued to decrease (-3.5%). Real Estate funds also recorded a reduction in AuM (-2.1%) in spite of the higher real estate prices. With the exception of flexible funds, the evolution of CIS in TS by fund type reveals a continuous upward trend in AuM. Equity Funds lead the sector with a significant increase (+16.8%) during the first three months of 2015.

The AuM of Securitisation Funds barely changed since the end of 2014 (a slight decrease), apparently not affected by ECB’s policy in this area (to buy funds in the securitisation market).
Graph 53– CIS in TS by fund type (€ Million)

Graph 54– Net Inflows by Investment Instrument (subscriptions minus redemptions) - € Million

Source: CMVM. Note: Latest available data – 2015Q1

Source: CMVM, APFIPP, ASF (Ex-ISP), BdP and IGCP.

Graph 55– Investment management in Portugal by fund class (€ Billion)

Graph 56– Variation of Net Asset Value by Investment Instrument - € Million

Source: CMVM.

Source: CMVM, APFIPP, ASF (Ex-ISP), BdP and IGCP.
In terms of the dynamics of subscriptions and redemptions, up to March, the year has been positive for Public Debt (sold to individuals as Savings Certificates [Certificados de Aforro] and Treasury Bonds [Certificados do Tesouro]) in line with 2014. But this is not expected to continue throughout the year, as those products were refurbished with a much less competitive return. All the remainder of the investment instruments analysed had net in the period (subscriptions minus redemptions close to zero).

Regarding fund flows, PCA is used to construct linear combinations of fund flows in order to detect general patterns in how investors reallocate money across fund categories. The first two principal components explain most (56%) of the total variance in the data. The first principal component (named ‘generic demand’) weighs positively (although not uniformly) across all fund categories, and hence may be perceived as a generic demand effect, accounting for the general shifts in and out of en masse investment funds. The fact that the first principal component alone explains about 37% of the variance in net flows suggests significant co-movement among fund investors in Portugal. It can be argued that this first principal component captures a broad investor sentiment pertaining to the investment fund sector.

20 Funds are aggregated into Bond Funds (including Bond Funds of Funds and Bond Hybrid Funds), Equity Funds (which also encompasses Equity Funds of Funds, Equity Hybrid Funds), Money Market Funds and Treasury Funds. This approach is based on the idea that a set of variables shares a latent structure, and PCA is then used to isolate the underlying common features across several time series while expurgating idiosyncratic characteristics.
In contrast, the second principal component indicates that the next most important driving force behind fund flows is a polarity between safer (Money Market Funds, Treasury Funds and Bond Funds) and riskier fund categories (Equity Hybrid Funds, Equity Funds and Equity Funds of Funds). This risk-safety contrast suggests that, controlling for the generic demand effect, when cash flows out of the riskier fund categories, it tends to flow into the safer categories, in what is generally referred to as “flight-to-quality”. This, in turn, supports the idea that flight-to-quality movements are also present within fund flows in Portugal.

There has been a steady increase in demand for investment funds from 2012 onwards, stemming from positive net inflows into both safe and risky fund categories. In particular, demand for safer funds remained high until mid-2013, due to increasing net inflows into Money Market Funds and Treasury Funds. Towards the end of 2013, however, while demand for risky funds continued to be positive, safer funds recorded substantial outflows (particularly Money Market Funds), suggesting a shift away from safe funds and into risky fund categories. During the second half of 2014, both the generic demand and the demand for safer funds exhibit a significant drop, on the back of a widespread decrease in net inflows across virtually all fund categories, suggesting a loss in investor confidence. However, since the end of 2014, general demand for investment funds shows a noteworthy recovery, supported by substantial net inflows to Bond Funds, but also Equity Funds. Furthermore, flight-to-quality reverses to negative values, determined by net outflows from Treasury Funds. Taken together, these recent developments suggest that investor confidence in investment funds is back on the path to recovery and that fund investors are more willing to invest in riskier fund categories.
Trading

In most developed markets, the weight of lit venues (i.e., traditional regulated markets) in the overall trading activity of stocks has been decreasing, especially if compared to pre-crisis levels or even to late 2008 figures. Portugal has been trailing some of its European partners where this phenomenon has been less intense. Nevertheless, the average weight of the lit market decreased from 58.7% in 2013 to 56.3% in 2014 (72.4% in 2009), as the off-book trade (i.e., transacted over the counter) increased to an average weight of 39.6% (37.3% and 25.2% in 2013 and 2009, respectively). The most recent figures represent a comeback of lit markets, as they represented less than 50% of trading in several quarters. This venue fragmentation and trading dispersion poses a challenge to market oversight: important regulatory provisions still differ between traditional exchanges and other trading platforms.

Having established “where” and moving to “how much”\(^{21}\) reveals that, in the second half of 2014, aggregate liquidity declined in Portugal, Italy and France, only to pick up again in the beginning of 2015. Market liquidity\(^{22}\) increased during the last months in the

\(^{21}\) The available data on liquidity refers only to lit market trading.

\(^{22}\) The Liquidity Composite Index (LCI) is computed by means of a principal component analysis on nine liquidity proxies (bid-ask spread, effective bid-ask spread, Roll’s measure, market turnover, turnover ratio, Lhh, Amihud Illiquidity Indicator, Zero’s measure and Market Error-Correction). When LCI crosses the X-axis (denoting a value of zero), it means that the liquidity in that period equals the average liquidity of the full period considered in the sample. Conversely, a negative (positive) LCI indicates that liquidity is lower (higher) than the sample average.
four countries under analysis, with France, Spain and Italy already recovering to the figures recorded prior to the Lehman Brothers' bankruptcy. The Portuguese market was affected by a major shock that resulted from the collapse of Banco Espírito Santo in July 2014. Thus, it is not surprising that the liquidity indicator exhibits a negative peak in that same month, and that it has remained below the sample average.

While liquidity has been in a roller coaster for the last couple of years in the Portuguese stock exchange, short-selling, as a percentage of market capitalisation, has been thriving, with an almost continuous increase between November 2012 and April 2014. Since then, a more wobbling behaviour has been revealed, almost as if reversing to a high level mean value. The latest available data shows, once again, high levels of short-selling (as a percentage of market capitalisation).
Graph 62 - Short-selling as % Market Capitalisation – Euronext Lisbon

Source: CMVM. Note: Latest available data – 28 February 2015

Transatlantic Trade, Investment Partnership and financial transaction tax

The Transatlantic Trade and Investment Partnership (TTIP), which includes financial services, is expected to be concluded by the end of 2015. Financial activity between the two sides of the Atlantic is likely to spike. But it raises questions regarding the ability to increase data accuracy, conduct on-site inspections or assess the likelihood of spillovers. Despite enhancing cooperation between the American and European authorities, the harmonising of regulatory frameworks may compromise the ability to legislate and undermine the effectiveness of future rules. A good example is the European attempt to create a financial transaction tax (FTT). In January 2015 the Governments of Austria, Belgium, Estonia, France, Germany, Italy, Portugal, Slovakia, Slovenia and Spain reaffirmed their intention to harmonise their tax regime for financial transactions by January 2016. This tax is not without risks; FTT can eventually harm the capital markets’ efficiency by promoting the relocation of investments to non-participating member states or a decrease in security issuance in FTT jurisdictions.

Short-selling indicators use the short-selling positions reported to CMVM (the statutory minimum reporting threshold is 0.2% of capital stock, pursuant to EU Regulation 236/2012). The market capitalisations of the shorted companies or the total market capitalisation for PSI20 companies is in the numerator.
4. Looking Ahead and Concluding Remarks

Looking ahead, the extent of the effectiveness of the ECB’s attempts to revive its transmission mechanisms in order to financially support real economy and bring inflation closer to the monetary policy target will determine the outlook for numerous economies in the upcoming months. The results of the latest stress tests on the EZ banking system revealed that several banks in a variety of member states were in need of capital, which somewhat contributes to the sentiment that the crisis in the European banking sector endures. The recent case of Banco Espírito Santo in Portugal, or the even more recent bond default of Heta Asset Resolution A.G. (the “bad bank” of Hypo Alpe-Adria-Bank International A.G., created by the Austrian government) also contributed to revive and highlight the sentiment of a still debilitated banking sector in Europe. In a nutshell, the profitability of the EZ banking sector still poses an important threat to financial and economic stability in Europe.

An environment of low interest rates and low growth prospects poses several challenges to financial stability. The combination of low inflation and excess liquidity can lead to the emergence of Ponzi financial schemes. Agents are prompted to take more risks and actively search for higher yields. In the medium-term, and in the absence of higher domestic return rates, investments may be diverted to third economies. Europe may face important capital outflows, with negative repercussions on market confidence and liquidity. The impacts should be more pronounced in an open, small and fragile economy as Portugal. This also resonates with doubts on the ability of the Portuguese exports to regain momentum (as predicted in the European Commission’s spring 2015 economic forecasts) and with the question regarding the consequences of the already significant decrease in investment that has marked the Portuguese economy since 2008.

The ECB has been increasingly assuming a looser monetary policy stance and it has broadened its intervention in volume and in scope (namely by directly buying corporate and sovereign debt in secondary markets). This did not come without criticism and some risks have been pointed out by several leading economists and even partially admitted by ECB officials. It may entail risks, especially if the monetary policy measures are not precisely targeted. With TLTRO, the ECB signalled that the new lending facilities would not fund additional real estate credit. However, with the ABS and covered bonds purchase programme and, since March 2015, with a full blown QE policy, it is questionable if some of the targeted liquidity will not end up on the usual bubble-prone markets. This preoccupation finds support in the exuberant evolution of most stock market indexes worldwide, which has seldom been accompanied by strong economic growth.

The dual objective of strengthening bank capital and
deleveraging the most indebted banks, along with the need to fuel credit to the real economy, has proven hard to attain. To stress the risks of the QE, one should highlight that ECB officials have been louder in asking for complementary fiscal policy measures, a field of action that is reserved to national governments. The fiscal policy stance in the EZ is also posed to be a risk factor in the following months. If the QE is not accompanied by higher aggregate demand, the negative effects of the QE alone, or at least its ineffectiveness, could prove to be real.

Another downside effect can be a drying-up bond market liquidity, with a negative impact on volatility, as it might be illustrated by the recent abnormal fluctuation of German bond yields. Furthermore, with the proliferation of negative sovereign yields in the EZ, yield seeking investors can increase exposure to less safe bonds. This can prove beneficial to the Portuguese sovereign market but even the attractiveness of Portuguese bonds could be significantly reduced as their yields come close to or go below zero. Although not a near-term risk, this could jeopardise the country’s ability to raise additional capital in the market.

The reasoning for these adverse effects of the QE could stem from the initial proneness for new bubbles: the low effectiveness of policy transmission could end up leading to increasing risks of bubble formation in the securities and real estate markets. It could even lead to the reinforcement of deflationary forces via “artificially” deflecting capital from lower yield real economy investments towards the exuberant behaviour of the ballooned securities and real estate markets. Thus, further inducing savings to ride and fuel new bubbles, and hindering new investment and actual demand that could stimulate investment. In other words, if excess liquidity does not flow to households and non-financial corporations, growth and prices may not pick-up. If this scenario materialises, long-term economic prospects for Europe may be rather pessimistic: a period of persistent low inflation, weak economic growth, low corporate profitability, and high unemployment rate. In particular, member states under strong adjustment processes will face additional difficulties to recover.

The first, although still scarce macroeconomic indicators for 2015 show that growth prospects are positive; the “road to deflation” seems to have been stopped and some signs of successful transmission have been recorded, with increases in consumption and production. But the latest (April 2015) PMI indicators, both for the services and industry sectors hint at an alignment in the major EZ economies, one that reveals that the economy could no longer be accelerating in the beginning of 2015Q2. This is certainly a subject worth following closely in the upcoming months. If the GDP growth rate does not pick up more or less evenly in the EZ, and in a lasting way, in this environment of very low interest rates, several latent risks in the banking, insurance and investment management sectors could materialise.

In general, equity markets have responded positively
to expansionary monetary policies, but the effect can be distortive. European and American stock markets have reached historic highs, although not without higher volatility. This raises the question as whether there are signs of equity market overvaluation. The empirical evidence in the US and in the UK (which have undergone QE programmes in recent years) warns not to ignore the hypothesis of potential risk for several markets and, eventually, for financial stability. Although economic growth has been more noticeable, especially in the US, securities markets have been hitting historical records, which do not seem to be completely aligned with economic fundamentals. In the UK, securities markets have been close to exuberant and there are indications of potential over-heating in the real estate market (especially in the London region and high-end dwellings), also while global inflation keeps subsiding.

Could the QE in Europe, especially as the single policy instrument to deal with low inflation, low growth and still ill-solved consequences of the financial crisis, ultimately put additional aches in the already worrisome search-for-yield behaviour? Will the European Commission’s Junker plan, intended to stimulate private investment, provide the balance required to shift investment towards the real economy?

In conclusion, the challenges of the ECB and European leaders are twofold: to preserve financial stability and avoid the so-called ‘secular stagnation’ in the Eurozone.

The discussion of institutional reform in the EZ and in the EU as a whole is bound to reappear in the agenda, upon the conclusion of the election of the new European Commission. The institutional reform to be implemented, will come amidst an increase in external (G20 and IMF) and internal (France and Italy) pressure to revise both the national budgetary targets and the role of public investment in the not so indebted European countries, as well as the role of fiscal policy altogether. The ECB has also been an increasingly vocal player in asking (though asymmetrically, country-wise) for a clear, reinforced intervention on fiscal policy, to help boost aggregate demand, which, by now, the ECB recognises as being a hindrance on European economic prospects in the near and medium run. However, the enduring uncertainty regarding the outcome of the political debate between Greece and its EZ partners on the unsolved problem of a depressed Greek economy and its debt obligations has prevented further advances in the medium- to long-term discussion on institutional reforms.

As regards the reduction of borrowing costs, Member States are still facing several obstacles in credit access, and this problem is expected to remain in the agenda. Sovereign spreads are still higher than before the crisis. As a result, financial market fragmentation persists and increasing divergences in the EZ can create a negative snowball effect in distressed economies. Besides the macroeconomic impact (fiscal revenues, competitiveness, investment), financial markets
can suffer from a potential liquidity squeeze.

For Portugal, IMF voices concerns about the high level of sovereign and private debt. Albeit in an expected downward trend, household and non-financial corporate gross debt will remain higher than in other advanced economies at least until 2020, according to the IMF. Furthermore, high credit level constitutes a barrier to the proper functioning of the bank-lending channel. This also raises the question as to what extent can the Portuguese economy benefit from ECB’s expansionary policy.

In addition, and considering the capital requirements introduced by Basel III, banks are encouraged to improve the quality of their assets and compelled to act as buffers to cushion pro-cyclical or systemic risks. In order to strengthen their capital structure, banks may need to raise additional capital, stressing the importance of capital markets and the need to reinforce the interdependence between international financial institutions. Competent supervision authorities from different jurisdictions are urged to work in closer cooperation and establish a comprehensive framework to avoid regulatory arbitrage, as well as to detect and curb systemic risks in useful time.

Moreover, market based financing is on the rise and is identified by the IMF and the ECB as an increasing risk to financial stability. Market-based financial intermediation comprises a large spectrum of activities and a broad variety of products (some highly opaque and complex), which are difficult to identify and address. The European Union recognises the importance of these activities and, together with the G-20, is committed to developing proper mechanisms to increase data accuracy, improve transparency, and promote more efficiency in the identification and mitigation of risks and vulnerabilities in market-based financing activities. The European Commission has recently presented legislative proposals on Money Market Funds and on the reporting and transparency of securities financing transactions. Imposing access to more comprehensive information, upholding thorough surveillance and better, more harmonised regulation can promote confidence and upgrade market-based financing from a looming risk to an important instrument for economic efficiency.

In addition, the European Commission has put forward a plan to build a Capital Markets Union. Even though it is proposed to strengthen the internal market for financial services, diversify sources of funding and mitigate the banking crisis effects on taxpayers, in its current version, it is strikingly omission (for instance, it fails to address fiscal terms), which advises moderate enthusiasm regarding its effectiveness. There have been recent and ongoing regulatory changes within the European Community and, as a consequence, also in the Portuguese regulatory framework. Such developments aim at achieving further harmonisation, less information asymmetry, increasing overall transparency, facilitating market access to new non-institutional investors and issuers, bolstering security and market trust and allowing for more comprehensive market

For the time being, these are some of the currently predictable future focal points, many derived from the recent past, that could pose challenges and lead to significant shifts in the status quo, with potential impacts for Portugal, the Eurozone and also on the global economy and global markets.
5. List of Graphs

Graph 1 – GDP growth (yoy) and forecasts for selected countries .......................................................... 10
Graph 2 – Portuguese exports (€) of goods by destination - 2014 .......................................................... 10
Graph 3 – Differences in the latest consecutive GDP forecasts for selected Countries ................................. 14
Graph 4 – GDP at market prices (2005=100) ............................................................................................ 14
Graph 5– Government Consolidated Gross Debt as a Percentage of GDP .................................................. 14
Graph 6– Per Capita GDP at market prices (€) ............................................................................................ 14
Graph 7– Overdue loans - Portugal (in % of total credit granted) ............................................................... 15
Graph 8– Difference in the breakdown of the % of non-financial corporations with overdue loans ............ 15
Graph 9– Gross total doubtful and non-performing loans in the balance sheets of domestic banking groups and stand-alone banks (% of total debt instruments and total loans and advances) .................................................. 16
Graph 10– New loans, respective interest .................................................................................................. 16
Graph 11– Net issuance of debt securities – Short- vs Long-term - Portugal ............................................... 17
Graph 12– Outstanding amounts of debt securities issued by NFC - Portugal ........................................... 17
Graph 13– Net issuance of debt securities by NFCs - Portugal ................................................................. 17
Graph 14– Net issuance of long-term debt securities by NFCs - Portugal .................................................. 17
Graph 15– Change in credit extended to households in Portugal and the Eurozone (mortgage and consumer credit) - % ................................................................................................................................. 18
Graph 18– Velocity of Money in the Eurozone .......................................................................................... 22
Graph 19– Spread between Euribor 12 Months and Harmonised Index Consumer Prices (HICP) - Portugal and Germany (percentage points) ........................................................................................ 22
Graph 20– HICP – Selected countries and Eurozone (percent change) .................................................... 22
Graph 21– Number of Houses Sold ............................................................................................................. 22
Graph 22– House Price Index (yoy) - % .................................................................................................... 23
Graph 23– Housing Banking Appraisal Values by Region and Total (euros/m²) ................................................................. 23
Graph 24 – Spread between Portuguese 10-year sovereign bond yields and 12-Month Euribor (percentage points) ................................................................. 24
Graph 25–Nominal Bond Yields (10-year government bond yield) – Percentage Points ................................................................. 25
Graph 26– Spread Towards German 10-Year Bond Yields – in Nominal Terms – Percentage Points ................................................................. 25
Graph 27–Real Bond Yields (10-year government bond yields minus HICP inflation rate) – Percentage Points ................................................................................................................................. 25
Graph 28– Spread Towards German 10-Year Bond Yields – in Real Terms – Percentage Points ................................................................. 25
Graph 29 – Commodities (Price indices in USD; 100 = Jan2009) ................................................................................................................................. 27
Graph 30 – Co-movement of Sovereign and Private Debt Yields, Stocks, Forex and Commodity Indexes .... 27
Graph 31 - Correlation between Equity and Commodities ................................................................................................................................. 28
Graph 32 – Stock Market Indices ................................................................................................................................................................................................. 29
Graph 33– Equity Realised Volatility ................................................................................................................................................................................................. 29
Graph 34– Difference between the stock market earning yield and the 10-year Treasury bond yield ................................................................. 30
Graph 35– Value-at-Risk, selected indices ................................................................................................................................................................................................. 31
Graph 36 – Positive and Negative Sentiment (weekly data) and Economic Sentiment Indicator ................................................................................................................................. 31
Graph 37- CAPE – S&P 500 ................................................................................................................................................................................................. 32
Graph 38– PSI20 – CAPE and Earnings ................................................................................................................................................................................................. 32
Graph 39- CAPE – MSCI EMU ................................................................................................................................................................................................. 32
Graph 40– Price to Book Ratio - Banks ................................................................................................................................................................................................. 32
Graph 41– Present Net Value of Growth Opportunities ................................................................................................................................................................................................. 33
Graph – PSI20 monthly average dividend yield ................................................................................................................................................................................................. 33
Graph 43– Average implied risk premium - Portuguese Markets ................................................................................................................................................................................................. 34
Graph 44– CISS for Portugal, contributions coming from each of the sub-indices and the overall contribution from cross-correlations (weekly) ................................................................................................................................................................................................. 35
Graph 45- 10-Year Sovereign Debt Yields ................................................................................................................................................................................................. 37