Portugal sheds PSI fears as rising debt officialisation reduces restructuring gains, but potential haircuts steepen

Portuguese bonds have pulled off a stunning rally since the start of the year. The significant shift of ownership of the country's debt to the official sector has reduced the efficacy and hence likelihood of a Greece-style PSI debt exchange, turning the market increasingly bullish. But if Portugal does end up restructuring the write-down, which would be shouldered by a smaller number of private creditors, it could be in excess of 70% significantly increasing the downside, buysiders, strategists and an economist cautioned.

Portuguese spreads to bunds have fallen from 1,621bps and 1,218bps on two- and 10-year paper to 749bps and 845bps in the last three months, taking outright benchmark yields to 7.55% and 10.28% respectively, according to Markit.

In price terms this corresponded to a nine point rally at the front end to 97 with the long end of the curve appreciating by 15 points to 63. Over half of the outperformance at the long end took place over the last six weeks whereas the bulk of the rally at the front end occurred by mid-April. Portugal's ultra long-dated bonds have jumped by five points in the last two weeks to around 50 yielding 8.6%.

The sovereign's five-year CDS spreads - a better gauge of fundamentals due to the LTRO distortions in the cash market – echoes the shift, having given up 361bps or 7.57 points upfront to 959bps-mid (29.76%) over the same three-month period.

"Part of this has a been a result of closing out of fast money shorts but mostly it was down to real money investors putting money to work, " said a strategist. The market has also started to believe the troika that Greek PSI was a one-off, and applying it to Portugal would have a negligible impact on debt sustainability. Portugal's consolidation program looks attainable as does the political willingness regarding implementation, he added.

"We are seeing the short end of the Portuguese government bond market being well bid by local investors, mainly pension funds," said Louis Gargour, chief investment officer of LNG Capital. The recent rally in government bonds has forced some capitulation from hedge funds, he added.

At today's 107% debt ratio and sky high yields Portugal's debt dynamics look unsustainable yet the case for Portuguese PSI looks more and more remote with every passing day due to the change in debt composition. Portugal's debt projections have not deteriorated since the onset of the programme in June 2011 in stark contrast to its big brother Greece.

Shrinking share of the pie

The amount of "PSI-able" bonds in Portugal could amount to around 35% of the total today, according to Gabriel Sterne, an economist at Exotix. This excludes treasury bills (normally excluded from a restructuring) and bonds held by Portuguese banks given their subsequent recapitalisation needs. "To secure meaningful debt reduction through PSI a vicious Greek-style PSI is needed now – a 70% or more haircut - or it is simply not worth taking the private sector to the barbers."

Portuguese debt is moving towards the point at which PSI alone is futile. The amount of PSI-able debt is likely to fall rapidly over time [...] with 46% of outstanding bonds due to mature by end-2014 the amount of PSI eligible debt could represent just 15% of the total, assuming new money is provided by official sector creditors, continued Sterne. "The window for an effective restructuring is likely to be missed or perhaps it has already."

The current bailout package assumes Portugal will be able to cover the EUR 9.7bn redemption of its 5.45% September 2013s, and based on its current valuation of 97 the market is pricing in that this will happen. "But with PGB yields still elevated and the ongoing debt crisis it's still uncertain whether it will be able to cover this financing [on its own]," said a second strategist.

Even if Portugal diverges from its deficit targets due to the self-defeating nature of the austerity reforms rather than political reform fatigue the troika will continue to fund Portugal, averting a second Greece-type scenario, said the second strategist.

“The German attitude to treat Greece as a unique and isolated case will in our view be held, especially as Portugal has shown a commitment to the implementation of its reform programme although it’s not plain sailing from here,” he commented.

Restructuring inevitable

PSI or not, Portugal will need some kind of action that alleviates the burden of debt which would otherwise continue to result in a misallocation of scarce resources into inefficient interest payments and redemptions, countered Gargour. “An extension of maturities like Ireland did at the start of the year or an interest rate concession through, for example, a coupon haircut are a few ways that would give Portugal some breathing room. We maintain our view that after the last disbursement of the IMF assistance in April the likely outcome is that Portugal will seek a restructuring along similar lines of Greece with PSI participation.”

Most mainstream economists would agree that inefficient allocation of resources starts to happen in countries running a debt-to-GDP ratio in excess of 90%.

Just like Greece prior to its debt exchange, Portugal has a heavily front-loaded maturity profile with EUR 19bn (or 18% of total debt) maturing by end-2013, increasing to EUR 32bn or 46% by end-2014. Its rollover ratio (percentage of debt maturing in 2012 as a percentage of 2012 GDP) is six, second only to Italy’s 7.4. And while the average residual life of the PGBs is 6.1 the modified duration of total government debt is sharply lower at 4.2, according to treasury statistics.

“The share of Portuguese sovereign debt held by residents is still running high at 52% (albeit down from 75% in 2007) meaning that only a slight turn in sentiment could lead to a proportionately larger jump in yields, especially due to the increase in long positions established by the market recently,” said Gargour.

In Greece non-resident ownership of government debt stands at 38%, giving some guidance as to how far the international investor base could dwindle.

Portugal has a solid track record under the troika program. Despite a 1.5% GDP contraction last year, which was 75bps milder than expected, the general government deficit dropped to 4% against a target of 5.9% and from 9.8% in 2010. This was in part due to the one-off transfer of banks’ pension funds to the tune of 3.5% of GDP. Excluding this one-off element the structural primary deficit managed to narrow by 3.6 percentage points to 1.7%, according to the IMF.

Competitiveness has also improved driven by wage declines and higher productivity resulting in more favourable unit labour costs (ULC). The current account deficit declined to 6.4% from 10% in 2010 owing to robust export performance which jumped 15% in real terms. Privatisations are also proceeding smoothly, something which Greece is falling behind on.

But going forward the contraction in growth is set to accelerate to 3.25% this year, increasing downside risks for the fiscal consolidation plan. The country’s overall government deficit will climb this year but in primary structural terms the adjustment still equates to 4% of GDP.

The government has committed to hitting a 3% government balance by 2013. Public debt is expected to stabilize at 115% of GDP next year and decline gradually over time to around 103% in 2020 and 77% by 2030 under the IMF’s baseline scenario. Crucially, this is based on a long-term average annual growth rate of 2% - not far off the 1.8% growth registered between 1997 and 2007 - and a return to the market in the middle of next year at yields of 7% on medium- and long-term debt that eventually falls to 5%.

“Even then The Troika is likely to commit to support Portugal up until 2015 at the very least to avoid spoiling its recovery with a premature return to the market in 2013 but the notion of Portuguese PSI cannot ruled out,” said the first strategist.

by Christopher de Vrieze