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# OBSERVATIONS ON THE GREEK DEBT CRISIS

From Across the Pond


Author

Tina Byles Williams

CIO & CEO


## INTRODUCTION

As Greece's negotiations with its creditors devolved over the weekend fostering a global rout in risk assets on Monday, through my attendance at a global investor forum in Europe, I solicited the thoughts of institutional investors that live and work closer to the epicenter of the crisis. Not surprisingly, I found a wide divergence of risk appetites and aversion. However, my overwhelming impression is that, while many recognize a high risk of short term volatility, investors here are quite sanguine about the medium and long-term risks of a Greek default or even a so called "Grexit". This document reflects my observations from the various presentations and conversations over the last few days. This commentary borrows heavily in particular from a presentation and paper by Marko Papic, from BCA Research.

## SYNOPSIS

Investors should expect further market volatility emanating from the ongoing negotiations regarding Greece's debt obligations, particularly in the context of looming Fed hikes and more demanding valuations. In this context, for risk averse investors, it would be prudent to delay increases in portfolio risk and explore currency strategies relative to the Euro. But regardless of the short or even medium-term outcomes of these political machinations, we do not see any meaningful uptick in systemic risk. Stay long risk assets and look for buying opportunities in the near-term.

## ANALYSIS

The Greek government's rejection of the conditions attached to a temporary extension of the rescue program proposed by the ECB last Friday, and the subsequent rejection of Greece's alternative proposal on Saturday, has resulted in a full breakdown in negotiations, the imposition of a bank holiday, capital controls to stem withdrawals and a referendum for this Sunday, July 5 on the austerity demands of Greece's creditors. Though ECB assistance has only been capped and not withdrawn (which would have created bigger problems for Greek banks), it would not have been possible to allow Greek banks to reopen as normal yesterday morning. Hence their closure on June 29, with only small cash withdrawals being allowed through ATMs.

It is critically important to note that the July 5 referendum is <u>not</u> about whether Greece should remain in the EU. It is really a referendum on the bailout proposal that was rejected and is no longer on the table. Rejection of the withdrawn proposal would not be the end of negotiations and it would not necessarily lead to Greece exiting the euro area. The formal process of an exit may take longer than anticipated, though a withdrawal of the ECB's emergency assistance in the wake of a failure by the Greeks to make a €3.5 billion payment due on July 20 could well be the catalyst. Athens will have around two weeks between the referendum and its ECB redemption to get a new agreement with creditor institutions and even a late payment to the ECB could be accepted by European creditors, as long as a deal is imminent or at least in the works. (Although Greece's debt to the IMF is due on June 30, this is not when a default will occur. Technically, a default to the IMF will only occur when the IMF has sent a letter to inform Greece of its non-payment. The letter should be written within 30 days of the missed payment. So strictly speaking, a technical default might not happen until mid-July when the payment to the ECB becomes due.)

That said, the probability of a continued near term sell-off is considerable, particularly in light of elevated valuations and continued musings of a Fed hike in September. A "No" vote would deepen the rout because the market has overwhelmingly discounted a Greek resolution, (as exhibited by low S&P 500 correlations and the recent sell off in bunds). On the other hand, a "Yes" vote in the upcoming referendum would create a significant buying opportunity, not only in Greek equities but also in European peripheral equities.

As discussed below, while recent events have obviously raised the probability of a so called "Grexit", this outcome is still not assured. (And even it did occur, we do not think that a "Grexit" would ultimately result in a systemic rout in Euro area equity markets akin to the Greek debt crisis in 2010.) However, a breakthrough towards resolution may trigger considerable socio-political risk in Greece – including potential new elections – and market volatility elsewhere in order to motivate the two sides to get a deal done.

### NOW WHAT?

A consistent lesson from previous Euro area crises is that deadlines are fluid and treaties can be mutable. First, the upcoming June 30 expiry of Greece's second bailout package and the default on its €1.5 billion payment to the IMF are now priced in and thus largely inconsequential. Second, the next key date is July 20, when a €3.5 billion payment to the ECB comes due. This date is important to watch because it will come after the July 5 referendum and will likely force the ECB to make a permanent decision on supporting Greek banks via the emergency liquidity assistance program (ELA). It is important to note that there are 15 days between the referendum and the critical ECB payment due date, during which a deal could be concluded amidst market and political pressure. Even after Greece defaults on its IMF payment, the decision for the ECB will be difficult. First, the ECB Governing Council will need a two-thirds majority to end Greek access to the ELA, which is not assured given support for a lenient approach towards Greece among several critical member states (i.e., France). Second, in the past the ECB has undertaken extraordinary actions to defend the "functioning of its monetary transmission mechanism". This could be impaired by its decision to cut member state financial systems off from ELA funding. Third, the ECB is now in charge of the Euro area banking union, which was specifically designed to sever the relationship between the sovereign state and its banks, a link that the ECB would make very real by pulling the plug on Greek banks due to a sovereign default. The bottom line for investors is that nothing is set in stone in Europe. Even rules that are techni-cally written down in treaties can be overruled and modified in times of crisis.

## THE GREEK REFERENDUM VOTE ON JULY 5.

Handicapping the referendum is extremely difficult. Two recent polls suggest that a robust majority (50%-60%) of Greek citizens supported the June 23 proposal submitted by Tsipras to European creditors. On the other hand, the next few days are going to give the Greeks a glimpse into what life outside the euro area could look like. Fear is a great motivator, and many voters could be swayed at the last minute to vote for the status quo. We also expect the opposition, the Greek business community, and international policymakers to campaign forcefully against the government. Importantly, the majority of Greeks consistently poll in favor of remaining in the Euro zone. A "Yes" vote, would lead to SYRIZA stepping down and a new government being elected. Though the shape of a political successor is highly uncertain, this result will make clear that there is no democratic wish to separate from the single currency project.

## WHY THIS LATEST BREAK DOWN MAY BE THE BITTER MEDICINE REQUIRED FOR RESOLUTION.

In such negotiations, all parties are both motivated and constrained by the wishes of their domestic constituents; or, in the case of the IMF, its di¬vergent membership. Over the 5 year crisis environment, which has characterized the euro area, European policymakers have used often manufactured crises to advance unpopular policies such as bailouts, ECB intervention, austerity, painful structural reforms, and further integration. Each crisis, market riot, and subsequent round of social unrest creates an environment that gives policymakers the catalyst to push through policies that are otherwise unpopular. The following is a brief description of the constraints governing the relevant parties:

Greece: The June 23 proposal caused immediate backlash for PM Tsipras among senior members of SYRIZA who went to the media with their objections. It was therefore unclear that Tsipras could even get his offer pushed through parliament, had it even been accepted by the European creditors. The referendum is as much a strategy for Tsipras to break down opposition within SYRIZA as it is a negotiating strategy vis-à-vis the Europeans.

Europe: Keeping Greece in the euro area is unpopular across the currency union, particularly in Germany. Additionally, mounting US pressure on the EU to strike a more realistic negotiating position that involves debt relief may over coming days elicit some change in what the EU is able to offer in terms of another set of proposals. Any realistic and longer-lasting 'deal' needs to begin by acknowledging that even after the substantial earlier write-down of Greece's private sector debts, the official debt is essentially still unpayable in full. US statements on the problem are clearly recognizing this even though the EU's pronouncements seemingly do not. Policymakers are in a bind not just in how to resolve the current situation, but also in terms of how to offer Greece a third financial assistance package and more debt restructuring later in the year.

It is also important to note that the ECB is also conscious of potential moral hazard relative to both Italy and Spain. Based on 2013 World Bank statistics, these two countries account for 12% and 8% of total EU GDP respectively, far more than Greece. Both have improved under austerity although both also face significant challenges (an unemployment rate in 2014 estimated at 12.5% for Italy and 24.3% for Spain — CIA World Fact Book). Additionally, Italy has been unable to capture its underground economy which is estimated to be about 17% of GDP. Finally, policymakers in Italy and Spain also have an incentive to play hardball, lest they encourage their own left-wing parties by giving SYRIZA a victory.

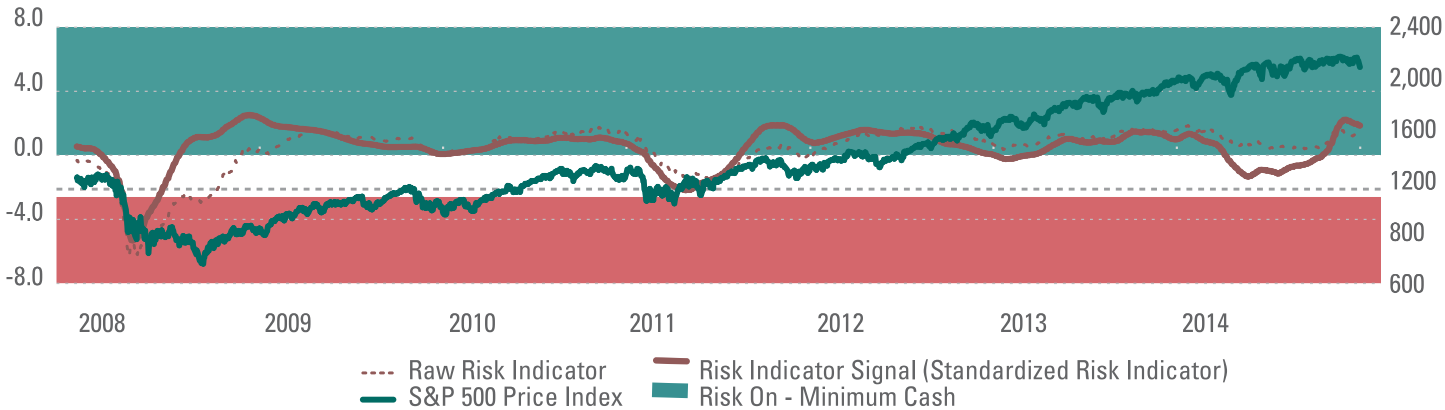
IMF: Director Christine Lagarde has come under criticism from emerging market members for leniency towards Greece, an advanced economy. Furthermore, the IMF has an interest in playing hardball with Greece today, lest it be forced to be lenient with a major EM economy in the (near) future.

## FINALLY IF A "GREXIT" WERE TO OCCUR WHAT ARE THE RISKS OF SYSTEMIC CONTAGION?

Our global systemic risk indicator has been a reasonably reliable gage of significant increases in systemic market risk. The green section of the chart below indicates a "risk-on" market environment, white is "risk-neutral" and red is "risk-off". In the last 5 years indicator has signaled market deterioration tied to policy events:

- Moving to "risk-neutral" in the first quarter of 2010, (the first Greek crisis)
- Moving to "risk-neutral" in July 2011 and "risk-off" by

CHART 1 Global Equity Market Systemic Risk Indicator




*Source: FIS Group professional estimates*

September (the second European credit crisis as well as the S&P downgrade of US sovereign credit)

- Moving to "risk-neutral" in early May 2013 (the onset of the "taper tantrum")
- Moving to "risk-neutral" more recently in September 26, 2014, which preceded last year's risk rout associated with the sharp depreciation in the price of oil and appreciation in the US dollar

Importantly, while in 2015 it clearly indicates that the equity risk environment has deteriorated, it has not crossed into the risk-off threshold (see CHART 1 above).

In the medium and long term, we believe a Greek exit from the euro area would have a minimal impact beyond the immediate turbulence and shock to European business confidence. There are five major reasons for this:

Lender of last resort: Unlike in 2010-2012, there is no longer any doubt whether the ECB is willing to act as a lender of last resort to the sovereign nations that make up the euro area.

Sovereign QE: Not only has the ECB evolved from a monetarist institution focused on its single mandate of price stability, but it is in fact today actively buying sovereign debt as a matter of monetary policy, at a clip of €45-50 billion worth of sovereign debt a month. Furthermore, the ECB could revive the Securities Markets Program (SMP) and simply buy peripheral debt with no regards to limits or qualifications, as it did in 2011-2012.

Public ownership of Greek debt: Unlike in 2010-2012, Greek debt is no longer held by the private sector outside of Greece. Two bailouts and two debt restructurings later, most Greek debt is held by the public sector, either directly by its euro area peers, European institutions, or the IMF. A Greek default would therefore increase sovereign liabilities and force euro area member states to access the international debt markets. However, it is unlikely that investors would balk at Italy's debt-to-GDP rising from 132% to 136% of GDP.

Greek economy: The Greek economy has contracted by 26% since 2010, which means that its negative impact on the rest of the euro area has already been priced in and digested by the wider regional economy. Further deterioration is likely to impact regional economies, from its Balkan neighbors in the north (Serbia and Bulgaria in particular) to Turkey in the east, where Greek banks have substantive operations. Even then, Greek banks only own local banks as separate businesses, they do not provide these local branches with liquidity. Beyond this, the contagion would be limited. Given that it represents only 2% of euro area GDP, and with paltry demand for imports from the rest of Europe due to its five-year depression, Greece is simply not capable of providing a major catalyst for a downturn, beyond what its collapse and euro exit would do for regional business confidence. As such, a Greek exit would perhaps resemble last year's geopolitical tensions with Russia, which primarily impacted business confidence. Once digested, these negative effects would quickly dissipate over the next two quarters.

Shifting investor sentiment: Five years into the euro area crisis, Greece remains the black sheep of the currency union. It has been unable to tap international debt markets and its policymakers have been unable to navigate a mix of austerity and structural reform policies. This is not the case with the other countries that were originally affected by the crisis. Ireland and Portugal have been able to conclude their international debt programs and have accessed international debt markets. Structural reforms have progressed, particularly in Spain. With the ECB standing ready to defend the debt markets of these member states, it is highly unlikely that Greek contagion would spread to the rest of the European periphery beyond the short term. As such, we continue to recommend that investors seek opportunities in the European periphery on a strategic timeline, although we advocate looking for a better entry point following any Greece-induced market riot.

*Please see important disclosures included on the next page.*

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