

GREEK TURMOIL AND THE POTENTIAL IMPLICATIONS FOR INVESTORS

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The Greek Prime Minister Alexis Tsipras surprised everyone at the weekend by calling for a referendum on the latest proposal from the bailout institutions. The referendum was approved by the Greek parliament and will ask whether the electorate supports the latest proposal from the bailout institutions. This has ushered in a phase of elevated uncertainty with heightened Greek exit fears and market turmoil. This note highlights some of the potential implications for investors.

The referendum will be held on Sunday 5 July and will come at a time when Greece will likely be “in arrears” to the International Monetary Fund (IMF) with a payment of €1.6 billion due at midnight Tuesday 30 June. The payment is likely to be missed without access to the funds available under the current bailout agreement. The bailout institutions rejected a call from Athens over the weekend to grant a one month extension to the current bailout. Patience is clearly wearing thin.

The Greek people are already getting a taste of life outside the Eurozone with banks closed, queues at ATMs and limits on the amount of funds that can be withdrawn. The European Central Bank (ECB) has also suspended Emergency Liquidity Assistance to the banks.

Mr Tsipras has said he will campaign for a “no” vote, which could put him at odds with electorate. The Greek people will likely see this vote for what it is: a referendum on continued membership of the Eurozone. Various polls have suggested the Greek people want to stay in the Eurozone, even if it means more pain.

A “yes” vote would likely open the door to fresh negotiations. But it’s hard to see how Mr Tsipras could then continue to negotiate on behalf of the Greek people, and fresh elections could be called.

A “no” vote seems likely to put Greece on the path to exit from the Eurozone, with further considerable pain for the Greek economy. The Government would need to

balance its budget immediately and IOUs would have to be introduced to meet salary and pension payments until a new currency could be introduced. That currency would depreciate leading to significant inflation for many basic consumer goods.

POTENTIAL IMPLICATIONS FOR INVESTORS

Our base case is Greece will stay in the Eurozone but if it does exit we believe contagion will be limited to a short term hit to confidence and growth. The rest of the Eurozone is in far better shape now than in 2010-12, with Portugal and Ireland now both off bailout support, while peripheral countries have reformed their economies and reduced their budget deficits.

In addition, the ECB now has the tools in place to support both banks and governments, including its long-term refinancing operation (LTRO) and Outright Monetary Transactions (OMT) programme. These will help break the negative feedback loop between the two that we witnessed in 2011 and 2012. Also, most Greek debt is held by official institutions, and European banks are better capitalised than they were a few years ago.

Greece represents about 0.25% of world GDP, which is roughly the same as New Zealand’s share, so it should not have much impact on global growth by itself. However, growth and confidence in Europe is still quite fragile so there is a risk recent positive momentum will be lost as business and household ‘animal spirits’ take a hit once again.

The Eurozone will be the epicentre of any market fallout if Greece does exit the Eurozone but the ripples will be felt across the world. Under this scenario, we should expect share markets to decline and core bond yields (US, Germany, Japan) to rally. Spanish and Italian government bond yields will rise but nowhere near levels we saw a few years ago.

The US dollar (USD) should also rally in a Greece exit event which implies the NZD/USD should decline. But given the Eurozone would be potentially stronger without Greece, the euro currency could actually rally if Greece exits the single currency.

Given our view that a Greece exit would not be a global systemic event, any material correction in share markets would represent an opportunity to add risk. Equity risk premiums are above long term averages and a move lower in both equity prices and bond yields would further raise expected returns from equities over bonds.

We think an overweight to cash is a prudent strategy at present. There is not much value in bonds at current yields and if Greece does not exit the Eurozone, core yields will likely rise. In contrast, cash is a defensive asset in most scenarios and can be deployed quickly as opportunities present themselves.

Our central view remains that growth will pick up over the second half of 2015 and 2016, led by recoveries in the US, China, Japan and Europe. We expect the unfolding tragedy in Greece to dent but not undermine this trajectory.