30 June 2015

Greece update and implications

While only accounting for 2% of Eurozone GDP, Greece carries (by a large margin) the highest amount of government debt in Europe, relative to the size of its economy. Based on 2014 data, total debt is around 170% of its annual GDP. This has been a focus of negotiations in recent months between the Greek government and its lenders regarding the terms on which their current support, dating back to the country's bailout package from 2012, could be extended.

What has happened?

The Greek government has announced a referendum for Greek voters to cast their vote on the latest proposals from its lenders. The referendum is scheduled for 5 July, this coming Sunday.

However, the Greek government is due to repay the IMF €1.5bn today, and this is unlikely to be made. This payment being in arrears could in principle trigger the acceleration of repayments due on other government debt, although any firm enforcement of this is likely to be deferred until after the referendum has been completed.

The European Central Bank (ECB) has been providing liquidity to Greek banks while discussions have been ongoing. The level of support has been capped for the time being, while Greek banks are likely to remain closed until after the referendum, with most people only able to withdraw €60/day from ATMs.

Referendum outcome to drive direction from here

Opinion polls from earlier this month suggested that the majority of Greek voters would prefer for the country to stay in the Eurozone "at any cost", even amongst supporters of the governing Syriza party. This should weigh heavily on the voting outcome.

A vote in favour of the creditors' proposals would see a clearer path to agreement, as well as a likely government reshuffle to maintain political credibility. Not only could this see Greece remain in the Eurozone now, but it would also lower the probability of it leaving in the future.

A vote against the proposals could be used as stronger negotiating leverage, but would more likely see a wider government debt default or restructure. This would create a need to recapitalise the Greek banks which currently rely on Greek government support. This could potentially be supported by the European Stability Mechanism (ESM), a "firewall" fund created in 2012 to provide such emergency assistance, but if this were not to proceed, Greece would likely have no alternative but to leave the Eurozone.

How is the rest of the Eurozone affected?

The result of previous debt restructuring, and the extended negotiation process, mean that the wider European financial system is much less exposed to Greece than before. Over 70% of government debt is held by multi-lateral organisations such as the International Monetary Fund, the European Central Bank, the European Financial Stability Fund (EFSF) and the ESM. The level of international private sector funds in the Greek banking system has also substantially reduced.

Since several years ago, the framework of regional support in the Eurozone has also been strengthened. In addition to the creation of the EFSF and €450 billion in untapped lending potential within the ESM, the European Central Bank now plays a stronger role in supporting the banking sector, and more broadly via

Quantitative Easing. The ECB has announced that it is closely monitoring market conditions and will use “all instruments” to support its supportive policy stance. Both aspects mean that the indirect effects are more able to be managed than previously. This has been reflected in the lion’s share of bond market concerns showing in Greek bonds rather than other peripheral countries.

How have portfolios been affected?

World share markets have fallen 2.5% on average this week, given disappointment following the lack of agreement between Greece and its creditors. The S&P 500 is down 2% while European shares have given up 3%, effectively reversing last week’s gains. Both New Zealand and global bond yields have fallen, with some potential for the Federal Reserve to now take a more cautious stance and look to delay increasing its Fed Funds rate. As a result, fixed interest sectors have supported returns. Combined with the effect of options protection over both United States and European stock markets, a balanced portfolio* is down less than 1% since the referendum announcement, and remains on track for moderate positive gains for the June quarter overall.

Looking forward

Markets are likely to remain volatile while this process is ongoing, and for a time thereafter if the outcome is an exit for Greece from the Eurozone. The shorter-term ramifications of this would be more painful for Greece, but our current expectation is that for the rest of the Eurozone, the associated volatility would likely be temporary. Policymakers would be expected to utilise their wide range of tools to ring-fence the flow-on effects as much as possible, while economic growth has been rising across the region. Among peripheral countries, Italy has exited recession, while growth in Portugal and Spain has been running at good levels. A likelihood for the Euro currency remaining low would also help support overall regional competitiveness.

While therefore expecting the broader global ramifications to be limited on a fundamental level, we will nevertheless continue to monitor the situation closely, and in the interim please do not hesitate to contact us with any queries.

*Greek bonds are not included in Grosvenor’s global fixed interest investments, and Greek shares are not included in either our European ETF or Vanguard’s International Shares Index Fund. There is a very small allocation to Greece (0.3%) within Vanguard’s Emerging Markets Fund.