The Greek Theater Will Reopen Soon

Analyzing the Impact of a Potential Greek Exit from the Eurozone

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Key Points:

- The recent negotiations between Greece and its creditors have brought back fears of a possible Eurozone (EZ) breakup, with Greece being the immediate candidate for departure from the currency union.
- At Windhaven, we strive to capture opportunities but also to manage risk by attempting to minimize drawdown in the event of negative scenarios, which can bring heightened volatility and risk aversion. Even after the recent four month extension of the Greek bailout package, an EZ break-up, with Greece potentially leaving, remains a tail risk.
- How is Windhaven positioned: we are maintaining exposure to safe haven assets at the short and long end of the maturity spectrum of U.S. government debt. We also believe that even in an adverse scenario, which includes a Greek exit from the monetary union, the German market is still likely to be the most resilient, and to recover faster given the fundamentals of the German economy and the tailwinds of quantitative easing (QE). In the event that the tail risk of a Greek exit does not materialize, German equities are very well positioned in wake of the sharp fall in interest rates, low oil prices and the quantitative easing program of the European Central Bank (ECB).

Greece vs Troika: Next Round in June?

Greece's politics and more recently the clash of the new Greek government with the Troika—the European Union (EU), the International Monetary Fund (IMF) and the ECB—have been front and center in the market narrative since the fourth quarter of 2014. The dissolution of the Greek Parliament in December, following the inability to elect a President with the necessary majority, and the outcome of the subsequent general election have been important drivers of the bouts of volatility that we have witnessed.

The current Greek government, led by the Syriza party (an acronym for Coalition of the Radical Left), has negotiated hard for a relaxation of the conditions imposed by its creditors in order to be eligible for the bailout funds that Greece needs to finance itself. Note that without an extension of the current bailout package Greece could run out of cash as early as March 2015, and therefore potentially be in a position to default on its obligations. Moreover, several unofficial sources are reporting large outflows from Greek banks, making them completely dependent on emergency liquidity provided by a member of the Troika – the ECB. Losing access to ECB liquidity could likely throw the country into financial crisis and a deep recession. It is also important to note that the extension of the program will have to go through a formal approval and ratification process, likely lasting well into March. This is when Greece has to make payments to the IMF amounting to €1.6B[1]. As such, there still remains a lot of uncertainty as to how Greece will make that payment ahead of receiving bailout funds.

The main bone of contention has been a relaxation of the primary budget surplus target. Prime Minister Alexi Tsipras and his finance minister Yanis Varoufakis would prefer the ability to spend a bit more for the sake of economic growth. The goal is to run a smaller primary budget surplus (a fiscal budget surplus excluding the interest payments on the outstanding government debt) in order to reduce the degree of austerity in Greece.

From a debt sustainability standpoint the request is not unreasonable. Under the terms of the current bailout, Greece is required to achieve a primary surplus of 4.5% of gross domestic product (GDP) and maintain it over time; while Greece is asking to reduce that target to 1.5% of GDP[2].

Note that on an annualized basis, the EZ, in aggregate, has never done better than the 4.1% primary surplus in 1999[3]. Since the euro's inception on January 1, 1999, only a handful of countries have managed to achieve at least a 4.5% primary surplus and maintain it for more than a year. Those are Belgium, Finland, Ireland, Italy and Luxembourg[4]. Moreover, under the terms of the EU's "Fiscal Compact" (formally the "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union") the achievement of a 60% debt-to-GDP target ratio for each member would require several heavily-indebted countries to run primary budget surpluses larger than 5%, for as long as a decade[5]. There are studies that show that in the last 40 years only three countries have managed to achieve such surpluses for such long periods of time: Singapore a city-state run by a benevolent autocracy, oil-rich Norway, and Belgium during a time of exceptional growth.

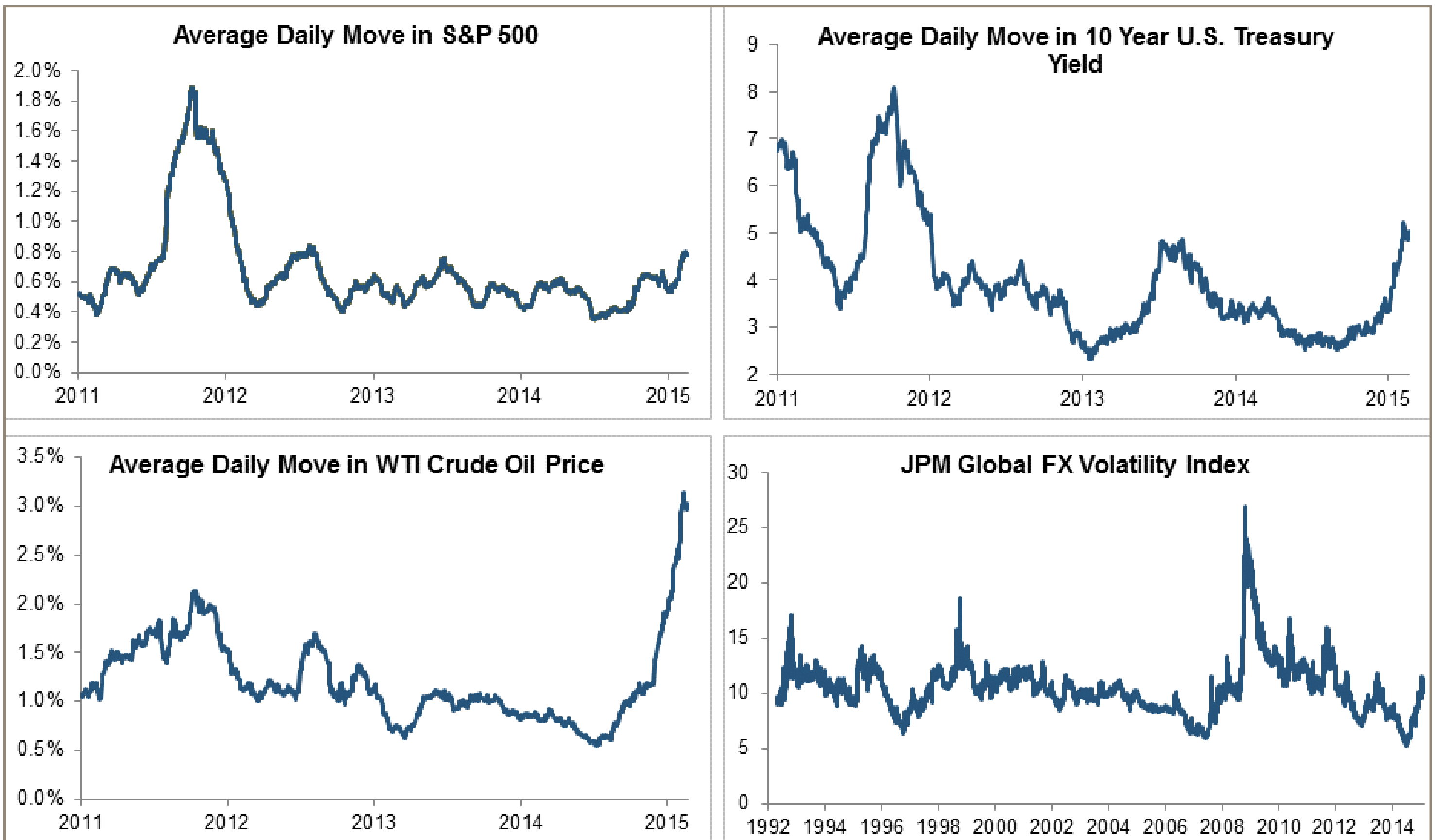
While the 60% debt-to-GDP ratio might remain a long term target, it is safe to say that the EZ will continue to have to confront debt sustainability issues in Greece, and other highly indebted members. There are four ways to solve a high debt problem:

- Achieving solid nominal growth, including positive inflation rates
- Fiscal adjustment which could hinder growth and become self-defeating
- Debt restructuring
- Debt default

In the case of Greece and much of the EZ, growth and inflation remain very anemic. Austerity and the fiscal adjustment needed are very onerous and have been a serious headwind to the return of growth as well as the driver of harsh recessions. Further future restructurings of large peripheral debts appear very likely.

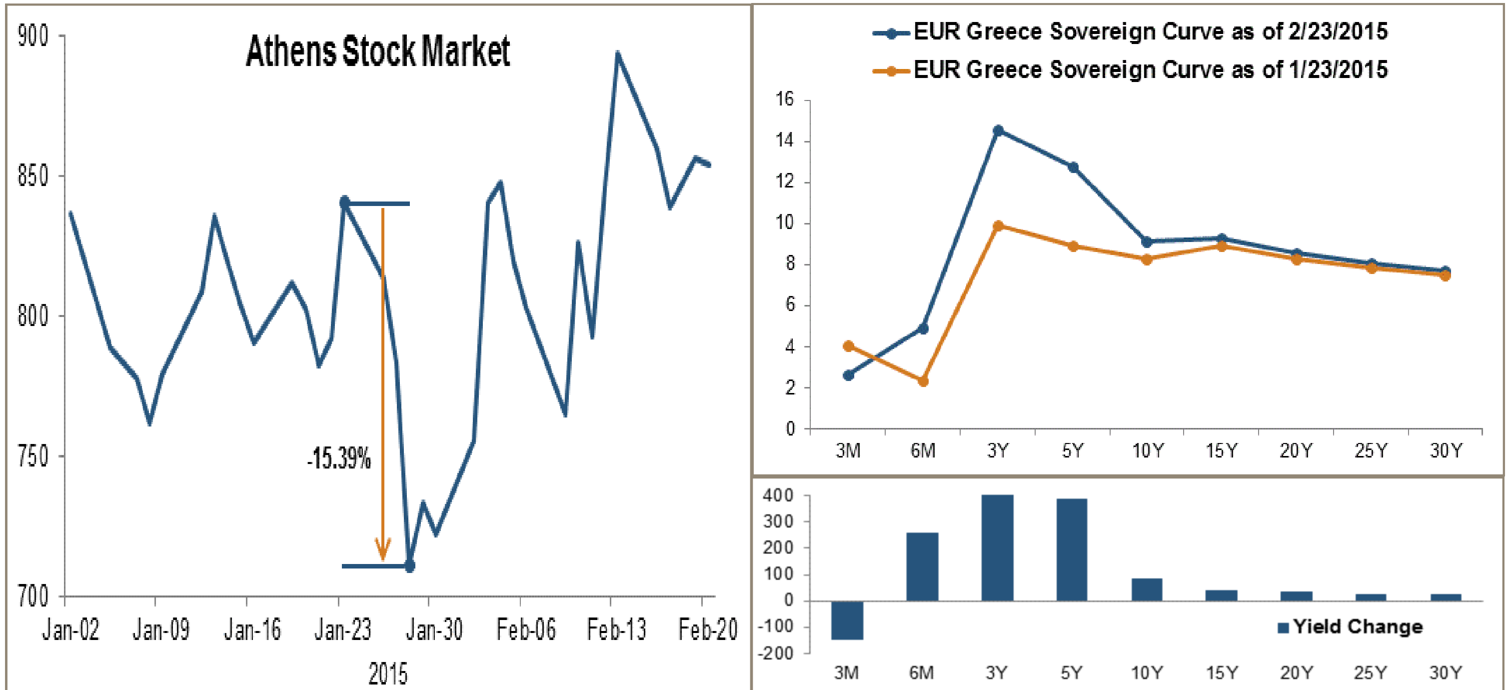
Is Greece Still Relevant?

Throughout the month of negotiation since the Greek general elections of January, a lot of the market narrative was around the heightened probability of a Greek exit or "Grexit." However, global market action was not exactly reflective of fears of a Greek exit even if January and February have been intense months for several asset classes with average daily moves and volatility on the rise.



Source: Bloomberg as of 2/20/15. Average Daily Move=50-day moving average of absolute daily change. U.S. Treasury is measured in bps=basis points. WTI=West Texas Intermediate. JPM Global FX Volatility Index is an index of global foreign-exchange volatility that tracks options on currencies of major and developing nations in percentage points.

Greek markets went into turmoil with equities fluctuating wildly, and bond yields shooting up both at the short and the long end of the maturity spectrum.



Source: Bloomberg as of 2/20/2015

Source: Bloomberg as of 2/23/15. EUR Greece Sovereign Curve is measured by YCGT156 Index.

Most other EZ markets have outperformed global markets due to a combination of positive macroeconomic surprises; low oil and forthcoming ECB QE have offset Greek exit concerns. Additionally, exposure to Greece across the EZ is now greatly mitigated by global “socialization” of Greek debt, given that over 90% is in the hands of global official creditors represented by the Troika. EZ bank exposure to Greece at this point amounts to about €20B, with the largest concentration (about €10B) in the hands of German Banks. These are hardly systemic numbers. So is Greece still relevant for the EZ?

There are two schools of thought:

- The first school of thought is that Greece is essentially no longer relevant. Private sector exposure to Greek debt is low; letting Greece go would not be a systemic event and at the margin would be better for the euro. Note that the euro strengthened following the Greek elections, while Greek markets tanked. That can be interpreted as EZ investors welcoming this self-inflicted election outcome which could potentially lead to drastic closure on the Greek saga: a Greek exit.
- The other school of thought is the one that worries that a Greek exit is a signal that the EZ has an unstable membership and other countries might follow the Greek template. This could lead investors to consider the euro in Germany as different from the euro in Portugal. As a consequence, we would likely see pressure on credit markets given that pricing action cannot go through the exchange rate, therefore exacerbating financial condition tightness in countries that need easing.

Both arguments have merit. We lean towards a break up being a negative market event that would lead investors to request a premium on EZ assets; but not a globally systemic event that could turn into a financial crisis. Moreover, we do not think that a Greek exit necessarily implies that others will follow suit. A Greek exit could result in a deep recession and financial crisis in Greece. However, given limited private sector exposure, contagion is likely to be limited. Moreover, the depth of the crisis would probably discourage electorates across the EZ to push for a similar outcome. Another note to be aware of is that later this year there will be elections in Spain and Portugal.

The net effect is that after the exit shock is reabsorbed, the EZ might actually look stronger in the eyes of investors. This is something that eventually might be reflected in the currency, given the large German current account surplus.

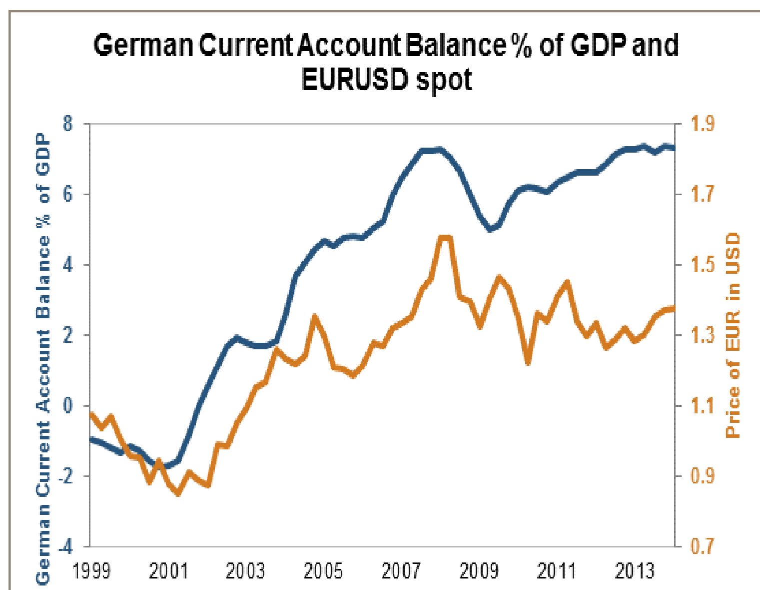
How Is Windhaven Positioned for a Potential Greek Exit

At Windhaven, we strive to capture opportunities but also to manage risk by attempting to minimize drawdown in the event of negative scenarios, which can bring heightened volatility and risk aversion. Even after the four month extension of the Greek bailout package, an EZ break-up, with Greece potentially leaving, remains a tail risk. As such, we are maintaining exposure to safe haven assets at the short and long end of the maturity spectrum of U.S. government debt.

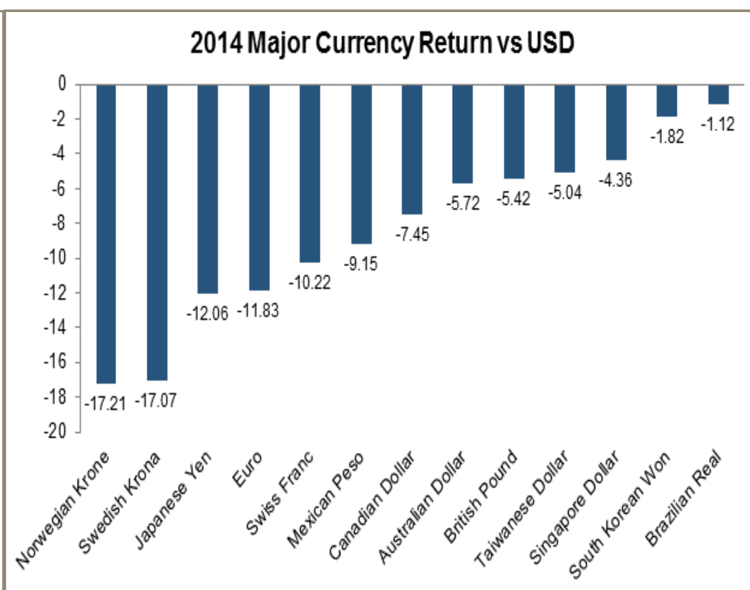
Our central view remains that the political capital behind the EZ project will avert a break-up. Moreover, EZ economic activity has been improving thanks to the tailwind of low oil prices and easing financial conditions across the region. We have therefore increased our exposure to the EZ by adding to our German equity position. We believe it is the most effective way to capture the EZ growth recovery story with Germany likely being an outperformer. There is also a likely potential boost to growth assets that could come from the aggressive QE program that the ECB will begin to implement in March. We also believe that even in an adverse scenario, which includes a Greek exit from the monetary union, the German market is still likely to be the most resilient, and to recover faster given the fundamentals of the German economy and the tailwinds of QE.

While increasing our exposure to German equities we did hedge for currency swings. We believe there are several reasons to expect continued currency market volatility:

- The ECB is about to engage in a QE program that is estimated to absorb about 500% of EZ bond issuance. That is a very large number compared with the roughly 60% of U.S. issuance during the third round of U.S. QE in 2013. The ECB must be aggressive because the transmission mechanism is very different than in the United States given the absence of capital markets. ECB aggressiveness is likely to be accompanied by outflows, as investors and households portfolios rebalance in search for a higher yield. If that occurs it would likely push the euro into weaker territory.
- The U.S. economy is now in self-sustaining growth mode and the U.S. Federal Reserve will likely start raising interest rates some time in 2015. These factors will continue to be supportive of a strong U.S. dollar.
- Monetary policy divergence will be an important factor behind currency moves. However, the rate of change of global current accounts can have a strong impact as well. A further possible widening of the German current account surplus could put a floor under the weakening of the euro and eventually drive a rebound.
- An improvement in the EZ outlook for growth and inflation could also constitute a support for the euro going forward.
- Finally, it is hard to argue that a Greek exit would be positive for the EZ and the euro; however one could argue that once the dust settles investors might realize that an EZ without the weakest link of the chain actually looks stronger.



Source: Bloomberg as of 3/31/2014. German current account balance % of GDP is measured by EHCADE Index and Price of EUR in USD is measured by EUR Curncy.



Source: Bloomberg as of 12/31/2014

Sources: [1]Reuters/International Monetary Fund (IMF) [2]European Commission, [3]Bloomberg: EXPNPRDS Index, [4]International Monetary Fund (IMF) World Economic Database, [5]http://www.voxeu.org/

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