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Yves Cochez
Senior Vice President
Chief Investment Strategist

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THE FINAL COUNTDOWN

The Final Countdown is probably one of my favorite songs. At least it is when, for a few minutes, I act as if I am an accomplished guitarist, all from the comfort of my basement and thanks to the magic of Rock Band. Personally, I recommend a thorough inspection of the house beforehand as I don't particularly want my wife to witness the extent of my metamorphosis and the devastating impact that memories of times past can have on a middle-aged man.

Indeed, this is not exactly a new hit (it was released in 1986, the year Belgium reached the world cup semi-finals, and I am pretty sure this is not a very useful hint for many), but what is most interesting about the song is that it was recorded by a rock bank named "Europe". Although the band was from Sweden (and, as you would expect, all 5 members had long blond hair), today, most investors would think of a different country when faced with the words "Europe" and "final countdown" in the same sentence. For your information, this is the Greek translation of the final countdown - Η τελική αντίστροφη μέτρηση

Following the ratification of a second Greek bailout in February 2012, the Greek economy seemed to be on the right track with improved growth prospects, the achievement of a primary fiscal surplus in 2013 and 2014 and a gradual decline of the unemployment rate. But the country has now returned to a full-blown crisis since the leftist Syriza government took power in January, promising to end austerity and unpopular bailout programs. Given the new government's refusal to implement the terms of the current bailout program, the Troika (IMF, ECB and European Commission) has suspended the scheduled remaining and final tranche of aid to Greece (EUR 7.2bn). Both sides appear to be playing a dangerous game of chicken. But time is running out and, without the release of bailout funds, the Greek Government will not be able to make the next payment it owes to the IMF on June 5. The clock is ticking.

SHOULD I STAY OR SHOULD I GO?

Given the tremendous negative consequences a Greek exit (a.k.a Grexit) would have for the Greek economy, a more important question would be - can Greece afford to default on its debt and leave the Euro area? Over the past 6 years, the Greek economy has already shrunk by a quarter and the unemployment rate still stands above 25%. Although a default would not automatically trigger a Grexit, the likelihood of such an event would considerably increase and the European Union might very well decide to force Greece out of the Euro (and possibly also out of the European Union). The consequences would be devastating for the Greek economy as some economists point to a potential 50%+ drop in the country's gross domestic product. The Drachma would be reinstated as the official currency and the standards of living would significantly worsen. Completely cut off from global financial markets (similar to what happened to Argentina in 2002) and unable to access any funding from the Troika, the only option would be for the Greek Central Bank to print money in order to meet the government's payment obligations (pensions, civil servants' salaries, etc...). An already devalued currency would plunge even more and hyperinflation would become a real possibility. As the Greek economy relies to a large degree on imports for basic necessities such as food and energy, these imported goods will become immediately dramatically more expensive. The banking sector has already suffered from large deposit outflows (depositors, fearful of re-denomination losses, moving their funds abroad), but the situation would get even worse. Capital controls would have to be implemented as Greek banks would be cut off from the emergency liquidity support they can currently still obtain from the ECB. Most Greek banks would probably go under and the financial system would stop functioning. Further down the road, a weak currency may help Greek export competitiveness, but contrary to Argentina, Greece does not have valuable commodities. Despite an overwhelming consensus among Greek politicians and citizens that the Troika imposed fiscal austerity has gone too far, and a broad resistance to ongoing painful adjustments needed to secure the final tranche of the bailout (pension and labor reforms, spending cuts, etc..), the alternative of a default and Grexit is by far a lot worse. The simple fact is that Greece cannot afford to go. But what about the broader Euro-area? In recent weeks, rumors have intensified that the EU and the IMF are busy working on a "Plan B", based on the assumption that a Greek default would be "systematically controllable".

While the idea of a "managed default" (more flexible repayment terms) that would not necessarily trigger a Greek exit has been put forward, the Troika is also increasingly perceived to be prepared to deal with the aftermath of Greece leaving the Euro.

STAND BY ME

Is the Troika seriously considering a Greek default and exit? Are European officials really convinced that the risk of contagion into the rest of Europe is minimal? The current calm in financial markets does confirm that investors either believe that a default/exit remains highly unlikely or that the consequences will be manageable (outside of Greece). Granted, many things have changed since 2012 when a second bailout package had to be urgently put together. Indeed, the permanent European Stability Mechanism as well as the recently started QE program will help. The Outright Monetary Transactions (OMT) is in place and could be triggered by any country facing a severe funding crisis. Moreover, contrary to 2012, most of the Greek debt is now held by official institutions and not so much by European banks, thereby limiting the potential for a banking/credit crisis. From a political perspective, orchestrating a Greek exit would send a clear message to the political class in other parts of the European "Periphery" about the very real consequences of not implementing fiscal austerity and structural reforms. The truth however is that nobody really knows. There remains numerous ways through which a Greek default and exit could send shockwaves through the EU economy and global financial markets.

BREAKING UP IS HARD TO DO

We hope and pray that European leaders will weigh the very real negative consequences that a Greek exit could have on the Eurozone. Images of massive bank runs will send a very clear signal to depositors elsewhere in the Euro area that their deposits are not as safe as they thought – re-denomination will be seen as real risk and confidence in any ECB deposit guarantee scheme would immediately evaporate. As mentioned, a Greek default would lead to large losses for its creditors (IMF, ECB, EU Commission). Policymakers will therefore not be able to entertain the fairy tale that European taxpayers should not worry about lending to struggling countries. This will most likely render any new bailout politically even more toxic. More fundamentally, the world would realize that the Eurozone is reversible and, if one country can go, so can others. But the most powerful argument in favor of securing a deal that allows Greece to remain in the Euro area is the memory of what followed the collapse of Lehman Brothers. The devastating consequences were grossly miscalculated. The global financial system is a like a giant spider web, making it extremely hard to predict the path and magnitude of contagion.

Given the obvious extent of the damage a Greek exit would inflict on the Hellenic economy and given the uncertainty of the potential economic, financial, psychological and economic consequences for Europe, we remain convinced that the can will be kicked further down the road. Even if, at some point, some kind of managed default might have to be implemented, a Greek exit remains in our view highly unlikely. As a result, the current episode is probably only the season finale (and not the very last episode of the show, as was shockingly the case with "Revenge" two weeks ago). The Greek tragedy will probably continue to entertain us for a while but is unlikely to morph into a full scale crisis and will not derail the current positive momentum for both the European economy and equity markets.

I have left you with a palette of oldies to consider but, as I finish this note, I think the most appropriate choice might actually be "The Never Ending Story" (another nice haircut by the way).

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