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SPECIAL REPORT

Greece: Political Theatre or Something More?

The economic situation in Greece, along with potential sovereign default, has loomed over financial markets for so long that I think a vast majority of participants have tired of the issue and stopped caring. The consensus seems to be that a country whose output is only 1.7% of total Eurozone GDP (similar to Newfoundland's contribution to Canada's GDP) is almost a rounding error when it comes to economic analysis for the whole of Europe. According to this view, the entire episode is just political theatre, bordering almost on farce at times, and can therefore be ignored.

But before we write off Greece's potential default as a non-event, let's investigate two possible avenues of contagion: economic contagion and political contagion.

ECONOMIC CONTAGION

Economic contagion can be transmitted three ways: through trade, through an interconnected banking system and through financial markets.

Issues related to trade are the easiest to dismiss. Greece is a very small economy relative to the rest of the Eurozone and is fairly closed. As a result, the risk of economic contagion via trade is very small.

The banking-system issue is more complex. Back in 2011/2012, the risk of contagion through the banking system was very high. Banks across Europe had large legacy positions in Greek government bonds (GGBs). In 2012, 65% of all GGBs were owned by the private sector, predominately banking institutions across Europe. If Greece had defaulted then, the losses on levered GGB positions would have destroyed the banks' capital and potentially caused a cascading effect of losses, write-downs and deleveraging throughout the entire system.

Today, the situation is different, as there is very little exposure to Greece in the banking sector outside Greece. Only 11% of GGBs are owned by the private sector, and these are mainly in the hands of Greek banks and a few hedge funds betting on the probability of a Greek deal with its creditors. Therefore, the contagion channel through the banking sector has been effectively plugged.

It is important to remember that in 2011 and 2012 – when the markets were last confronted with the real possibility of a Greek default – Greece was not the only Eurozone country at risk. At that time, we were not discussing whether one small country was going to stay or exit from the

SUMMARY

- Greece is a very small economy relative to the rest of the Eurozone and is fairly closed
- Only 11% of GGBs are owned by the private sector, and these are mainly in the hands of Greek banks and a few hedge funds
- We are not dealing with a complete fragmentation of the monetary union
- The chance of real financial market contagion through capital flight out of the Eurozone is minimal
- The notion that defaulting on its debt obligations means that Greece leaves the Eurozone is misconstrued
- The economic risk is much less prevalent this time than the last time a Greek default was front and centre for financial markets
- Until the threat of a default passes, careful stock selection remains critical in all European markets

Eurozone; rather, we were talking about a complete rupture and collapse of the monetary union. That introduced a completely unhedgeable foreign exchange exposure into every euro-denominated asset: the risk of being redenominated back into a native country's currency (peseta, lira, punt, franc, etc.).

Back then, high profile international investors (e.g., Scottish Widows) were wholesale sellers of euro-denominated assets, as they had no interest in owning this unhedgeable foreign exchange risk. Multinational companies raced to match assets and liabilities in each European country and were careful in what jurisdiction their cash was located.

The fundamental rule of a monetary union was at risk of being violated. A euro in one country was not worth a euro in another. Euro bills include in their serial number a two-letter code identifying where the bill was printed. There were stories of German shops not accepting euro bills with serial numbers from the periphery countries.

The fundamental rule of a monetary union was at risk of being violated in 2012

This panic run on the euro ended in the summer of 2012 with Draghi's "whatever it takes" speech, where he made it clear that the European Central Bank (ECB) would do whatever was necessary to keep the Eurozone together. At that point the euro stabilized and Eurozone assets began to recover.

The issues in 2015 are different. We are not dealing with a complete fragmentation of the monetary union — just the possibility of one small country defaulting and potentially leaving the Eurozone (although it is not legally clear how one leaves the Eurozone, or the EU — see *Political Contagion* below).

Investors have had plenty of warning that this Greece train wreck was coming and plenty of time to move or hedge assets and get portfolios to their risk tolerance. There is no unhedgeable foreign exchange risk exposure on non-Greek assets. The chance of real financial market contagion through capital flight out of the Eurozone is minimal.

Investors have had plenty of warning that this Greece train wreck was coming

In addition, a major difference in 2015 is that the ECB is operating a stimulative monetary policy, or "quantitative easing" (QE) program. This injection of liquidity into the system acts as a damper on financial market volatility, mitigating the risk of economic contagion.

POLITICAL CONTAGION

The Greek economic situation generally adheres to rational rules, making it relatively easy to analyze. The political and legal situation, on the other hand, is confusing and chaotic.

To begin, the notion that defaulting on its debt obligations means that Greece leaves the Eurozone is misconstrued. The Eurozone (monetary union) and the EU (free trade and free movement area) are governed by multilateral treaties. In neither treaty is there a mechanism to proactively eject a member. As long as a member is not in violation of the treaty rules, it is impossible for the others to kick it out. And defaulting on government debt is not considered a violation of the treaties. Even introducing capital controls and a parallel quasi-currency within domestic borders is not a violation according to some interpretations.

The point is that even after a Greek default event, the position of the country would be unclear. Since the treaties really do not provide any guidance, the answer would be a political solution that might take weeks or months to resolve.

Even after a Greek default event, the position of the country would be unclear

Beyond the complete political and legal uncertainty, if Greece were to default, it would be in the interest of the Eurozone political leaders for the country's economic situation to deteriorate significantly. The last thing the politicians in Brussels (or Berlin) need is for the Greek default to work out well for Greece. If it did, populist political forces would grow significantly in countries like Italy, Portugal and even France. If defaulting were seen to work, then everyone would want to do it, and it would be the de facto end of the Eurozone.

The Eurosystem, which is the network of national central banks, could also be negatively affected in a couple of ways. First, the ECB owns GGBs and would take losses as a result. Second, the payment system that settles inter-country capital flows would be disrupted by the insolvency of Greece's banking system. If Greece the country defaults, then its central bank and domestic banking system are effectively insolvent. There is a small chance that the Eurosystem would need a capital call on the various national governments to recapitalize the ECB. Again, this would be a politically negotiated solution fraught with uncertainty.

CONCLUSION: ECONOMIC RISK SMALL, POLITICAL RISK UNKNOWN

The economic risk is much less prevalent this time than the last time a Greek default was front and centre for financial markets. And even if market participants don't know exactly what is going to happen from an economic perspective, they have had plenty of time to analyze and plan. As Donald Rumsfeld would put it, the economic issues are "known unknowns."

Market participants have had plenty of time to analyze and plan

Unfortunately, the political angle introduces some "unknown unknowns."

In the event of a Greek default, I believe the initial move would be for European risk assets such as equities to sell off. Some of the weakness in European equities over the past six weeks may, in fact, be due to the markets' repricing a higher probability of this outcome. However, I believe that the market would very quickly get comfortable that there are no channels of economic contagion. Risk assets would bounce back and even trade higher in the short and medium term.

Political uncertainty, however, would last longer. A lingering doubt would begin to emerge about the ability of policymakers to keep the Eurozone project intact. This would show up in higher risk premiums across all European assets, but probably not right away, as the ECB's QE program continues to inject liquidity into the system. But ultimately, as we complete this economic cycle and embark on the next, this increase in risk premium will begin to reveal itself, with longer-term implications for financial markets.

As we complete this economic cycle and embark on the next, this increase in risk premium will begin to reveal itself

While it is clear that international investors should steer clear of direct exposure to Greece, select opportunities in developed Europe remain attractive. There are many large European companies with attractive valuations that generate worldwide revenue and are therefore largely insulated from the risks of contagion.

But with the political instability that would certainly flow from a Greek default, the prospects — and stock prices — of many other European companies could be negatively affected, at least until a political solution emerged. Until the threat of a default passes, careful stock selection remains critical in all European markets.

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Mr. Young is a Vice-President & Portfolio Manager focusing on fixed income strategies. Mr. Young graduated Summa Cum Laude from Harvard University with a Bachelor of Arts degree in Astrophysics. He received a Master of Business Administration degree from Stanford University, where he was an Arjay Miller Scholar and received the Alexander A. Robichek Award, given to the top student in finance. Prior to joining Gluskin Sheff in 2010, Mr. Young worked at Goldman Sachs for eight years in London, England as an Executive Director in the Interest Rate Products group, managing rate and volatility risk across the various European interest rate curves. He previously worked in the energy industry, structuring electricity and gas derivative transactions for the North American markets. Prior thereto he was a consultant with McKinsey & Company

Gluskin Sheff

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PROVEN[1]

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Similarly, many of our other long-standing investment strategies have outperformed their relevant benchmarks.

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For further information, please contact research@gluskinsheff.com

Notes:

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2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.

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