# GREECE: AT A CROSSROAD

EMIRATES INVESTMENT BANK

## Greece – What Happened:

Significant developments have taken place over the past weekend between Greece and its creditors as debt negotiations broke down between both parties due to their inability to reach an agreement on the level of austerity measures that Greece needs to implement. In response to the latest offer by Greece's creditors, the current Greek government – led by Prime Minister Alexis Tsipras – announced a referendum on July 5 to have the Greek people decide on whether they should accept or reject the austerity measures proposed by its creditors, which include additional pension spending cuts of EUR 1.8 bn in addition to a value-added-tax of 23% on most goods. The Greek government was voted into office due to its anti-austerity stance and as such has advised its people to reject the proposal. However, it has also committed to implement the proposal should it be accepted.

In the interim, the Greek government requested an extension of the current program of financial assistance which is set to expire on June 30th, in order to allow the referendum to take place. This request was rejected by the Eurogroup and will essentially leave Greece without enough funding in place to honor its upcoming obligations, the first of which is an upcoming USD 1.7 bn payment to the IMF on June 30.

In response to Tsipras turnaround, the ECB decided to maintain its Emergency Loan Assistance program (ELA) but capped it at last Friday's level at just under EUR 89 bn. The ELA program provides liquidity to Greek banks and allows the banking system to stay afloat. Deposit withdrawals have squeezed liquidity however and have forced the government to close banks and impose capital controls (i.e. Greeks are not allowed to take or transfer money out of the country). Banks are closed until July 6th at least and cash withdrawals are limited to EUR 60/day.

## Where do we go from here:

I. Scenario 1 (unlikely): The Greek government makes a U-turn by calling off the referendum and the negotiating parties agree on the austerity measures or at least go back to the negotiating table.

II. Scenario 2 (more likely): The outcome of the referendum results in an outright rejection of the austerity measures (i.e. Greeks vote 'no' against austerity). This increases the likelihood of an exit for Greece from the Eurozone, which may deter some citizens from voting against austerity. It's important to note however that the Greek people are not voting for or against an exit and most would actually prefer to stay within the Eurozone.

III. Scenario 3 (most likely): Greek voters accept the austerity measures being mandated on them by their creditors (i.e. Greeks vote 'yes' in favor of austerity). This increases the probability that Greece will stay within the Eurozone and also increases the likelihood that the current Greek government loses the public's confidence, which may result in new elections.

# How did the markets react:

Clearly, the outcome is still vague and each scenario leads to additional questions and uncertainties. In such an environment, investors will de-risk their portfolios until they receive further clarity. Investors tend to shy away from uncertainty and the elevated ambiguity due to the ongoing Greek saga has caused an adverse reaction across the global equity and fixed income markets. By mid-Monday, the Euro Stoxx 50 was down 3.6%, while the Spanish and Italian equity markets were each down 4%. Meanwhile, Japan's Nikkei was down 2.9% and China's Hang Seng continued to edge lower, dropping by another 2.6%. Within the sovereign debt space, flight to safety was evident as investors tactically repositioned out of peripherals (Italy, Spain and Portugal) and shifted towards higher quality core bonds (Germany and France).

That said, a Greek exit from the Eurozone is not a doomsday scenario and actually has positive and negative implications across the spectrum of outcomes. From an economic point of view, the overall banking system in Europe is significantly stronger than it was in 2011, being more liquid, more capitalized and less leveraged. As such, contagion from potential Greek exposures is likely to have less of an impact. Additionally, Greece's contribution to the Eurozone's GDP is around 2%, a relatively immaterial figure to cause any severe, long-lasting impact on the rest of the bloc. From a political point of view, the Eurogroup's strong stance against Greece may actually deter other anti-austerity campaigns in Spain and Italy from garnering additional support, which would actually decrease fears of a Eurozone breakup.

The current levels of European sovereign debt yields and Credit Default Swaps (CDS) rates indicate that investor fears are much more subdued today compared to the European debt crisis of 2011. The charts below show that 10Y yields for Spanish, Italian and Portuguese sovereign debt are well below the levels seen in 2011. We believe that the recent selloff was overdone and that peripherals, namely Spanish and Portuguese bonds, present an attractive entry point due to the ECB's continued QE program (which is expected to continue until at least September 2016).

**10 Y Sovereign Bond Yields**


Source: Bloomberg, 10 Y Yields rates for Portugal (Red), Spain (Black) and Italy (Green)

**5 Y CDS Rates**


Source: Bloomberg, 5 YR CDS rates for Portugal (Red), Spain (Black) and Italy (Green)

Lastly, the 5-day chart below shows that the Euro has held up pretty well in lieu of the political turmoil. The Euro did sharply drop by approximately 2% on Friday when the debt negotiations broke down. However, the Euro has since recovered, which could potentially indicate that a Greek exit is not necessarily negative for the Eurozone in the long term.

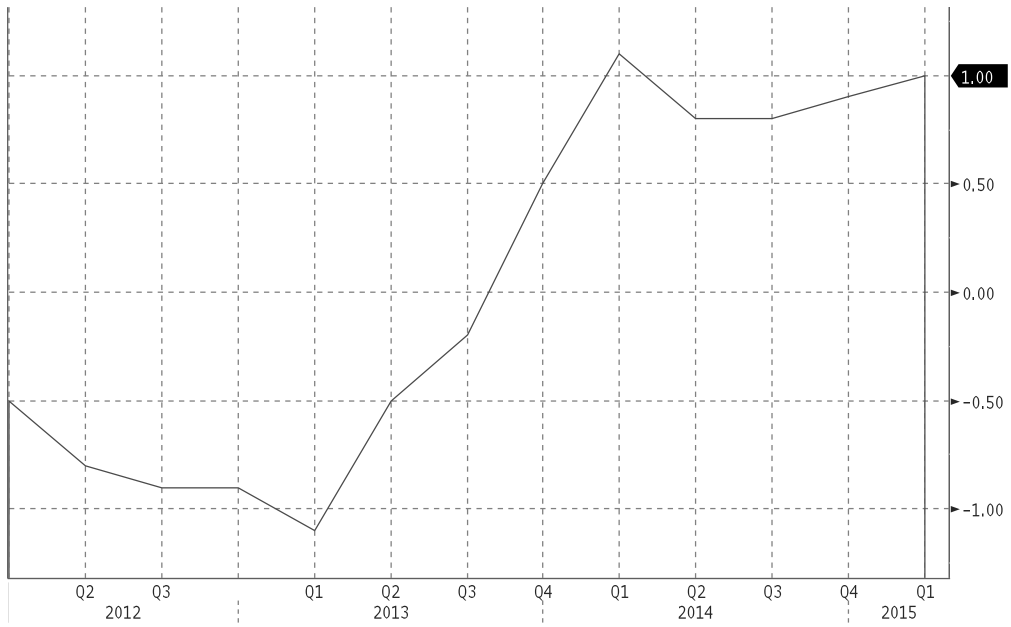
**EURUSD Exchange Rate**


Source: Bloomberg, EURUSD rate

# Strategy:

In our 2015 outlook, we favoured European equities and highlighted that "a supportive ECB, higher consumer purchasing power, a healing banking sector, and European valuations with global operations make us selectively favor equities." While the recent turmoil has created some short-term market volatility in both the equities and fixed income markets, all of these factors are still in place today. We mentioned that the ECB "will be forced to act in 2015 and address the bloc's structural issues and weaken the EUR, which will be positive for equities". The ECB has in fact acted through the launch of its QE program and the EUR has weakened, helping the Eurozone's export sector. Oil prices remain relatively low when compared to their levels a year ago, which is helping the European consumer, while the banking sector continues to deleverage. As such, the Eurozone's GDP levels have steadily edged back upwards from negative growth in 2012 and 2013 to around 1% today. The growth is relatively muted but its steady trajectory is positive and has come in above market expectations.

**Eurozone GDP Growth Rate**




Source: Bloomberg, Eurozone GDP Growth rate

We are less concerned with trying to predict whether Greece remains within the Eurozone or not, as a Greek exit is mainly irrelevant to our longer term fundamental views of the bloc and can actually have positive repercussions. In the interim, the outcome is likely to create market volatility and we would opportunistically take advantage of such market dislocations. We will continue to manage downside risk and as such we do not expect to add equity exposure until we receive further clarity on the outcome of the Greek referendum. We will continue to favour European equities and will look to add to our exposure should markets drop a further 5-10% from here.

| Index / Market | Last Price | PE 2015e | PE 2016e | PBV 2015e | Indicative Div Yield | 1 M % Change | QTD % Change | YTD % Change |
|---|---|---|---|---|---|---|---|---|
| S&P 500 INDEX | 2,058 | 17.4x | 15.6x | 2.7x | 2.2% | -2.4% | -0.5% | -0.1% |
| STXE 600 € Pr | 386 | 16.3x | 14.6x | 1.9x | 3.7% | -3.4% | -2.8% | 12.7% |
| FTSE 100 INDEX | 6,620 | 16.0x | 14.3x | 1.9x | 4.2% | -5.2% | -2.3% | 0.8% |
| NIKKEI 225 | 20,222 | 19.1x | 17.2x | 1.7x | 1.7% | -1.7% | 5.3% | 15.9% |
| SHANGHAI SE COMPOSITE | 4,052 | 16.5x | 14.5x | 2.0x | 2.0% | -12.1% | 8.1% | 25.3% |
| S&P BSE SENSEX INDEX | 27,674 | 16.1x | 13.7x | 2.8x | 1.8% | -0.6% | -1.0% | 0.6% |
| BRAZIL IBOVESPA INDEX | 53,014 | 14.4x | 11.2x | 1.3x | 4.3% | 0.5% | 3.6% | 6.0% |
| MICEX INDEX | 1,635 | 6.6x | 5.5x | 0.6x | 5.2% | 1.6% | 0.5% | 17.1% |
| S&P Pan Arab Comp | 811 | 13.6x | 11.6x | 1.7x | 3.9% | -4.0% | 2.5% | 2.0% |

Source: Bloomberg, Indicative Prices as of June 30, 2015

On the fixed income side, the ECB's QE program will continue to be supportive for European bonds and will act as a "safety net", preventing peripheral bond yields from increasing sharply. In early May, Spain 10Ys were yielding 1.2%, which have doubled to 2.4% since then. Meanwhile, the yield on Portuguese 10Ys have also doubled from the 1.5% levels to 3.0% over the same period. We believe the yields on both of these bonds present an attractive opportunity at these levels, especially when compared to German bund yields. Currently, Spain and Portugal 10Y are trading 1.6% and 2.3% over the German 10Y, which is currently trading at 0.75%. We expect the spreads to compress and believe the bonds are attractive on a risk-adjusted basis.

**Spain 10 Y Yield**


Source: Bloomberg, Spain 10Y Yield

**Portugal 10 Y Yield**


Source: Bloomberg, Portugal 10Y Yield

For more information,
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