Perpetual Investments

WILL GREECE PREVENT THE GLOBAL REFLATION TRADE IN FY16?

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Greece appears to be on the precipice of failing. Matt Sherwood, Perpetual's Head of Investment Strategy, Multi Assets, concludes that with a referendum to be held about any bailout deal after a rescheduled debt repayment to the IMF is due, Greece has little prospect of fully meeting its obligations to its debtors, public servants and pensioners in coming months. Accordingly, the ECB faces a monumental decision this week about whether it continues lending money to keep Greek banks afloat in the days before the bailout referendum, especially if the IMF repayment is missed which will call into question the solvency of the government and the banking sector. The ECB is not allowed to lend to insolvent institutions, and without sufficient collateral, and while it does not want its fingerprints on a decision which sees Greece become a failed state and exiting the European Union, it will have to draw the line somewhere. Market volatility is likely to rise but it won't prevent the global reflation trade in FY16 but it will delay it.

KEY TAKEOUTS

- Greece and Europe have much more to lose from a fracturing of the European Union than both realise. Even though a deal before 30 June appears highly unlikely, the Greek government must do whatever it takes to meet the reasonable demands of its creditors and the latter will need to agree to some form of debt restructuring. Even if a deal can somehow be struck before the deadline, the European Union and the International Monetary Fund will have to continue supporting Greece for many years to come given the current depths of its economic malaise.
- While markets have been focused recently on the €1.6 billion loan repayment to the IMF and the €7.2 billion bailout loan which needs to be approved to avoid default, there will need to be a third large bailout program negotiated later this year totalling around €50 billion. This program will have to be centred on decade-long loans with ultra-low interest rates, so that Greece's current primary Budget surplus can be used for debt repayments instead of interest payments. Whether or not this can be agreed is a key market risk.

INTRODUCTION

It has been another positive financial year of returns for investors despite increased angst about the situations in China and Greece and policy deliberations at the US Fed. Despite the associated increase in market volatility, investors went long the cyclical recovery given earnings improvements in Japan, Europe, the US and emerging markets with strong performances in the former two markets given the attractive starting valuations and positive economic growth deltas. Overall, returns were positive within all asset classes for a second consecutive year but in FY15 there was a slightly wider spread of returns. More importantly, financial year returns have moderated below their post-GFC average in most asset classes (see Chart 1) which indicates that the market recovery is now in a maturity stage, and lower returns in the next few years is likely as starting valuations remain stretched in all assets.

Interestingly, the valuation expansion once again accounted for the majority of the rise in most sharemarkets in FY14 with only five major markets experiencing more than half the price gain coming from earnings (Mexico, Japan, Hong Kong, Spain and Sweden). However, despite an improving economic growth environment there is no material improvement in the number of countries in the top 25 markets recording earnings growth in FY15 (11) than was the case in FY14 (11) and FY13 (10), with only three countries recording earnings growth in all of the past three years (China, the US and Japan) and only Japan recording three years of double-digit earnings growth.

THE KEY RISKS ARE MOSTLY KNOWN

Not only have the number of countries recording earnings growth not materially changed, but the risks to the global economic and global market sentiment have also been known for some time –namely, the US Fed, China and Greece. While, markets are currently focused on the start data for the US Fed's tightening cycle, it is really the pace and the nature of the increases in US Fed policy which is the key for markets. Indeed, in recent statements, the US central bank has gone out of its way to inform investors that the tightening cycle will be gradual and that they will not upset the delicate market equilibrium. Moreover, the People's Bank of China are well behind the easing curve given how far Chinese inflation has declined in the past year, but they are progressively easing official interest rates to boost Chinese economic growth.

... BUT GREECE IS THE GREAT UNKNOWN

Accordingly, the great unknown for FY16 is Greece. In the last weekend before a €1.6 billion is due to be paid to the IMF, Greece called off negotiations with its creditors in a unilateral move that has some thinking that the end to its six-year struggle against fiscal debt and exit from the European Union is perilously close. Why has it come to this? Because Greece has wasted five years not fixing the issues which beset its economy - if they had implemented proper solutions (reforming the tax system, selling assets, boosting growth and so on) they would

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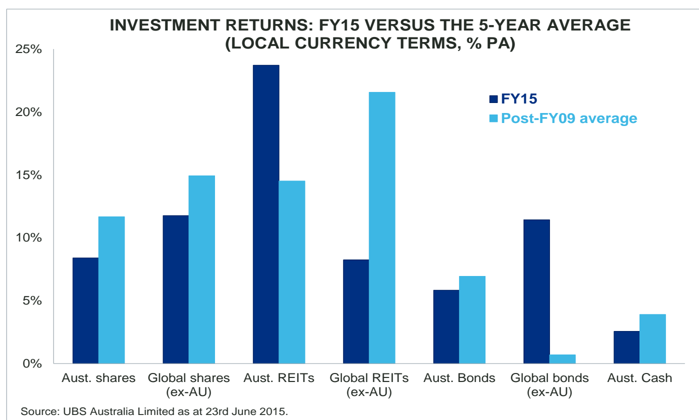
CHART 1: INVESTMENT RETURNS WERE POSITIVE BUT BELOW THE 5-YEAR AVERAGE



be seeing the results evident in other countries including Ireland and Spain who implemented broad-based unpopular reforms and their economies and asset prices have subsequently recovered.

A MONUMENTAL DECISION FOR THE ECB

In contrast, Greece hasn't done this and the economy remains stuck in its malaise. Consequently, long lines outside ATMs have started and the ECB faces a monumental decision this week – does it continue lending money to keep Greek banks afloat in the days before the weekend's bailout referendum. This matters, because Greece will almost certainly missed the 30 June payment to the IMF which will call into question the solvency of the government and the banking sector. The ECB is not allowed to lend to insolvent institutions and without sufficient collateral, which is declining each day that the Greek bank run continues. While the ECB will not want its fingerprints on a decision which leads to Greece becoming a failed state and exiting the European Union, it will have to draw the line somewhere.

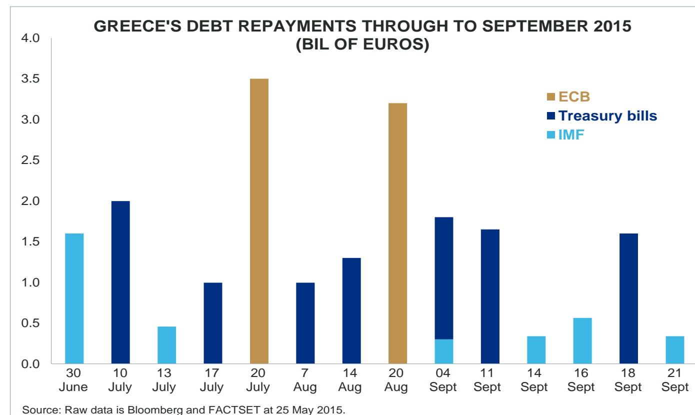
THE IMF REPAYMENT IS THE TIP OF THE ICEBERG

Even if Greek and its creditors can put aside their differences and somehow agree to a reforms-for-cash program, they will receive only €7.6 billion in bailout aid, whereas their total debt rollover until late September 2015 totals €20.3 billion (see Chart 2). These repayments are to organisations including the IMF, the ECB and owners of Government Treasury bills, who are typically Greek banks, and to a lesser extent foreign investors. Greece has previously managed to convince these investors to rollover their bill holdings, but with the country's position growing more perilous by the day, there is no certainty about this pattern continuing. On top of debt repayments and interest payments, Greece has to cover the usual costs of pensions and salaries for the public sector which total around €1.7 billion per month. Consequently, if Greece does not have the necessary funds to pay back the IMF loans on time they will have to choose between defaulting on the IMF (which puts them in the same league as Argentina) or asking the European Union for even more money.

GREECE NEEDS A LARGER BAILOUT

Whatever emerges from high-wire negotiations aimed at averting a Greek default and possible exit from the Eurozone, what's coming around the corner for these investors is an expensive fact - that Greece is likely to be reliant on the support of the European Union and International Monetary Fund for years to come because of the depths of its economic malaise and its ballooning debt.

CHART 2: GREECE HAS €20 BILLION OF REPAYMENTS TILL SEPTEMBER



IMPLICATIONS TO INVESTORS

In the current environment of low economic growth, stretched valuations and several large-scale binary risks, investors may be pondering their asset allocation. Regardless of your exposure to bonds and equities, this question is not as simple to answer relative to previous cycles given the immediate risk of Greece, which are on the precipice of failing and the Greek PM's decision to put everything to a referendum five days after their current IMF loan has expired indicates that there is little chance of an eleventh hour deal.

As such the ECB emergency loans which are keeping these institutions on artificial respirator are now in grave jeopardy and therefore the deposit flight from Greek banks were likely to accelerate until the Government declared a bank holiday and capital controls were inserted. The former would be best to save banks from financial failure but have a massive detrimental effect on the economy which would ground to a halt given the near-closure of the payments system, with unemployment certain to increase rapidly. In contrast, capital controls allow commerce to continue to a limited extent, but is much harder to establish, enforce and monitor, and banks need the cash on hand to meet withdrawal demand, which they probably don't have. The fortunate thing about this risk is that we have known about it for five years, and European banks have minimal exposure to Greek debt and the ECB has the tools in place to ring-fence the contagion risk. However, events like these are not always predictable, so investors need to prepare for an increase in market volatility, safe in the knowledge that all market turmoil ends and falling markets eventually become a reason to buy not sell.

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