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The Greek Crisis – The Second Episode

Greece has entered the second episode in its fiscal tragedy. As of last night, July 6, tensions mounted as Eurozone members debated what to do with the country and its expiring debt. This news comes just a day after the Greeks voted "no" in a bizarre referendum to a bailout that was in fact no longer available to them.

In our commentary last week on June 29, we noted that such a vote would likely result in Greece defaulting on all of its external debt obligations, as well as its decoupling from the common currency. It would be like a bankruptcy proceeding in which the debtor would remain in business as a result of a cram down in its debt obligations. Since its federal budget is close to being in primary surplus and its current account is in surplus, under more normal conditions, Greece should be in a position to self-finance its growth, if it has no external debt. However, the main impediment to Greece being self-sufficient is the imminent collapse of its banking system, and the delay in reissuing its own currency, which at best would be only partially convertible into the euro.

The Greek government hopes to avoid such a highly deflationary collapse through bail-in plans, some which call for at least a 50% haircut on deposits above €6,000, according to a New York Times article, "Eurozone Central Bank Now Controls Destiny of Greece's Battered Banks" dated July 5, 2015. This type of arrangement would be similar to the rescue plan accepted by Cyprus in 2013 when customers' funds were seized to shore up the banks. However, the Cyprus bailout was in the context of a major outside rescue program. Given the recent events of a "no" vote and weeks of delaying tactics, it is unlikely that members of the Eurozone would be willing to bear enough of the expense to help Greece in this way.

Despite the headlines, there are some positives in this drama. We believe a Grexit will not be as damaging as once thought to the private creditors of Greece, or comparable to the 2008 Lehman bankruptcy. Official creditors of Greece will likely have to write off or renegotiate nearly €350 billion in loans or failed interbank clearances, according to a June 19 article in *The Guardian*, "The Greek Debt: What Creditors May Stand to Lose." This loss will have to be dealt with through additional sovereign bond issuance driving up long-term interest rates in the core European countries. In the long term, a sans-Greece Eurozone might merit a stronger currency, but markets want to see more evidence that other members with excessive external debt will not be inspired to drop out before this happens.

Grexit will not be as black and white as most people imagine. As mentioned in our previous commentary, the new currency may be called an IOU, but eventually could be a new Drachma. Any return to a local currency would probably involve a dual exchange rate system. For most transactions, the local currency would not be convertible into the euro or any hard currency but could only be used for the purchase of local goods and services. The local currency could only be converted into hard currency at an official rate for certain international transactions approved by the government. Greece could not move within the foreseeable future to a fully convertible national currency, which would float in foreign exchange markets. Even the introduction of a new parallel currency would be extremely difficult, with the risk of hyperinflation. However, if handled properly, it could create enough purchasing power to stabilize Greek output.

The Greek referendum vote has the following investment implications:

1. The ECB is going to make it clear that it will not allow the Greek situation to spill over into other financial markets, which will probably prevent a protracted European equities selloff. It will concentrate on providing ample liquidity to financial markets throughout the Eurozone.

2. Short-term selloffs in European equity markets should be regarded as buying opportunities. European equities are already cheaper than US equities and the latest data from Markit show that the Eurozone recovery is stronger than expected. Similarly, the latest data from Now Cast published in Gavyn Davies' blog for *Financial Times* show that as of early July the global economy has resumed growing at trend rate, which means that the Greek problem should not derail the global recovery.

3. The euro is likely to weaken further against the dollar and in some cases additional European equity exposure should be accompanied by a currency hedge.

4. Major events always create uncertainty and opportunities to make or lose money. However, timing is often difficult and we recommend exercising caution; we will not try to buy or sell an intended amount of a security or asset class all at once.

5. The recent renewal of the Greek crisis has caused investors to become overly focused on the Eurozone and has distracted them from other potential opportunities.

6. The credit spreads of other peripheral countries, such as Spain, Italy, and Portugal, are likely to widen significantly and the interest rate on German government bonds is probably going to move above 1.0%. This will have spillover effects on US treasury yields and on credit spreads in the US corporate bond market. For this reason, we are maintaining below benchmark duration in our bond portfolio and we are not increasing our high yield exposure.

If you have questions about the economic situation in Greece and Europe, please contact our team directly at lerskine@drexelmorgancapital.com or 610-971-1901. We are monitoring the events closely and will provide you with additional updates as appropriate.

Disclosures

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