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Referendum commentary

6 July 2015

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Greece's 'no' vote: a buying opportunity for longer-term investors

The outcome of the Greek referendum appeared, if one believed the opinion polls, to be too close to call. We now, know, however, that Greek voters have decisively backed their government and rejected the latest eurozone/International Monetary Fund bailout proposal. So what happens now? I think the outcome from the "no" vote may, in reality, be little different from the outcome had Greeks voted "yes". It is just that the players on the Greek side might have been different had defeat for Greece's government resulted in a general election being called. As matters stand, I see no alternative but a return to the negotiating table for all parties.

The Greeks appear to believe their rejection of the creditors' proposals strengthens their government's negotiating position. The publication of an IMF report at the end of June analysing the sustainability of Greek debt has attracted less media attention than the referendum but may prove more influential in persuading the other eurozone members that are partial debt write-off must now be part of a negotiated settlement. The IMF findings are critical of the Greek government's "weak reform effort" and the deterioration in the situation since late 2014 when the IMF thought no further debt relief would be necessary. Regardless of where the blame lies, the IMF now considers the current Greek debt dynamics to be "unsustainable" and Greece's creditors will have to extend the maturities of the existing debt and provide further refinancing. If the reform effort is weakened further, an outright debt "haircut" would be necessary to restore Greece to a sustainable path of debt reduction.

Currency devaluation leading to capital destruction and inflation in the short term but a rebasing of the economy and the resurgence of economic growth in the longer term is a well-trodden path out of the mire for over-indebted nations. From 1978 to 1989, 19 countries defaulted on IMF loans as Greece has just done. Of these countries, however, only Sudan and Somalia were unable to clear their IMF debts eventually. In more recent years, Zimbabwe is the only country with long-standing arrears. Despite the potential benefits of a devaluation, which would be possible if Greece left the euro, the Greek people were not asked this question explicitly and there seems little evidence they would have voted in favour of bringing back the drachma. Staying in the euro seems only possible following a negotiated settlement. The resignation of Greece's finance minister, Yanis Varoufakis, could be seen as evidence of Greek willingness to negotiate. The IMF has said it wants Greece to embrace further reforms and would like its European partners to provide additional financing and, importantly, debt relief.

The Greeks may believe their 'no' vote will improve their negotiating position within the eurozone. Others think it brings Grexit, a Greek exit from the single currency, one step closer. Since 2011, when the eurozone crisis

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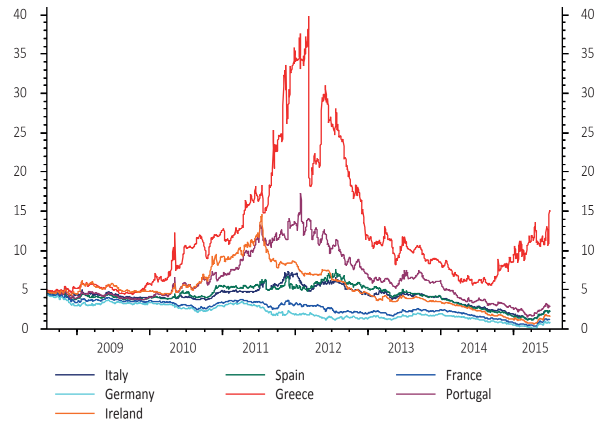
was at its height, the premium that investors have demanded to hold sovereign bonds issued by peripheral eurozone countries such as Italy, Spain and Portugal has reduced as the euro's fragmentation has seemed progressively less likely.

10-year eurozone government bond yields (%)



Source: Thomson Reuters Datastream

A Greek exit would, however, prove that the single currency was not irreversible and that members could both default and revert to their own currencies should austerity become too unpalatable. This would increase the cost of borrowing for the eurozone as a whole. It also opens up some potentially alarming questions regarding the scale of losses that might be incurred by remaining nations. A number of commentators have highlighted for example, the imbalances that have arisen in the "TARGET2" cross-border payment system, a key part of the mechanics of the single currency. Germany, in particular, might be exposed to significant losses if these liabilities crystallised. The full repercussions of a Greek exit on the rest of the eurozone are unquantifiable. However unpalatable further concessions may be to member nations that have already adopted more stringent austerity measures themselves, a forced exit for Greece might yet prove a far more damaging option.

Capital flight drove Asian stockmarkets down sharply once the referendum result became known. In recent weeks, I have reduced investment in Asia, where appropriate, within the Brompton investment strategies. European stockmarkets, however, fell only modestly in early trading as investors anticipated a political solution to the crisis. As all parties appear ready to head back to the negotiating table in Brussels, I still believe the current turmoil will prove a buying opportunity for longer-term investors.

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