Macro Matters.

Greece: Deal or No Deal

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Emiel joined LGIM in August 2013 as Head of Asset Allocation with responsibility for asset allocation, strategy and macro research.

He has wide experience in managing a range of multi-asset strategies, including absolute return, diversified growth funds, LDI and fiduciary, balanced mandates and multi-manager mandates.

Emiel graduated from Tilburg University with a Master's degree in economics and holds a post-graduate qualification from VBA/EFFAS (the European Federation of Financial Analysts Societies).

Hetal Mehta - European Economist

Hetal is a European economist and is responsible for providing macroeconomic research and forecasts for the fixed income, asset allocation and equity teams. She joined LGIM in 2011 from Daiwa Capital Markets where she held the role of UK economist. Prior to that, she was a senior economic adviser to the Ernst & Young ITEM Club and an economist at the Oxford Economics Consultancy. Hetal has also worked for HM Treasury and the Office for the Deputy Prime Minister. Hetal graduated from the University of Bath in 2004 and holds a BSc and MSc in economics.

We have been keen to write a Macro Matters on Greece for some weeks but, to be honest, multiple editions of macro matters have already landed in the bin as they had run out of shelf life faster than we could write them. The Greek saga is like Coronation Street: there is a guaranteed cliff hanger every episode and it never really ends.

The Greek government seems close to default. It is scraping the barrel to find funding for its ongoing paying commitments. The last payment to the IMF was only funded thanks to financial engineering. On 5 June, Greece asked the IMF to bundle its June repayments to month-end. This just proved how desperate the situation is, as this was the first time such an option had been exercised since Zambia did the same in the 1980s. Moreover, Greek banks are only being kept alive thanks to emergency funding by the ECB. They are bleeding deposits, with confidence fragile and a bank run not impossible. Pressures are mounting, yet the Greek government remains defiant. It's unclear whether this is all part of a big poker game or whether it is desperate, irrational behaviour from the Greeks. Russia may even act as a white knight, offering Greece a last minute loan. We always thought that negotiations between the Greeks and their creditors on an extension would go to the wire and this is clearly still the case.

Deal: temporary at best

Officially, Greece and its creditors are 'only' discussing the €7.2 bn extension of the current aid programme, which ends at the end of June anyway. If extended, the additional funds provided will only keep Greece afloat for a few months at best. It's basically the European Union lending Greece money, so the Greeks can use that money to repay the EU. After this money runs out, a new deal has to be put in place, a third bailout package. The Greek government wants debt relief in exchange for reforms (something the IMF is in favour of as well), which the creditors have so far been unwilling to contemplate.

No Deal: capital controls, not Grexit

The best outcome for now is that a deal is done to keep Greece in. But unless it includes debt relief, this would still be a temporary solution, with the clock ticking until the next funding crisis. Our base case scenario is still that a (last minute) compromise will be found, but nothing like a permanent solution. The Eurogroup will meet on Thursday (18 June), though limited progress is expected in this meeting. A (likely) failure would then lead to an emergency EU leaders' summit this weekend (ie 20-21 June), and another summit already scheduled for 26 June. These summits will realistically be the very 'last chances' of a deal. However, if there is no deal in the coming days, Greece would be unable to make some of the big payments due to the ECB in July, making capital controls very likely. This means measures would be introduced to stop the capital flight out of the banks – think bank holidays, restricted deposit withdrawal, and bans on credit card use and foreign payments – buying more time for further negotiations or preparation for a euro exit.

We still believe that, even after capital controls are introduced, a Greek exit from the euro zone (Grexit) would remain only an outside risk. A last minute deal remains the central case. Why? First, Greece is simply not meaningful enough for Europe to take the risks around the precedent of a country leaving the euro zone. Greek GDP is very small, equivalent to around a third of the London economy. Why would policy makers take a big risk with Grexit for what, in the grand scheme of things, is just a minor cost? Second, the downside for Greece in the form of economic and social costs is huge which, in the end, should make the leadership willing to compromise.

Grexit implications

This doesn't mean that we rule out a Grexit scenario. After all, policy makers can make mistakes and people do not always act rationally, especially under pressure and time constraints. Moreover, some in Europe seem fairly relaxed about a Greek exit from the euro zone. Since 2011, there has been an enhanced firewall around the European financial system – banks have increased capital, there is the European Stability Mechanism (ESM) capital able to bailout euro zone sovereigns, and we have an entire ECB alphabet soup of policy tools like OMT, TLTRO and PSPP[1]. Some claim the market has 'priced it in' and the Greek risks are small and ring-fenced. Some even suggest that it would be good for the monetary union. We wouldn't be so sure. We fear a Grexit – should that risk scenario materialise, we believe that it will have significant indirect and unintended consequences; for instance, by highlighting that the euro is no longer an irreversible currency.

We would then know that the euro is breakable. Peripheral yields could spike, and reassurance by the ECB and Europe's leaders would be less effective than last time as investors realise that they will not do "whatever it takes". As a result, next time a peripheral country is struggling economically, or elects an anti-euro party, speculation that it could exit will be that much greater. That matters – if investors think that any smaller country could exit, then why would you keep your euros in that country?

Portfolio positioning

What are the risks in our portfolios? The direct exposure to Greece in both equities and bonds in our Funds is tiny, as Greece's weight in the respective indices is very small. However, the real risk doesn't lie in any direct exposure; it lies in the contagion risk of a Grexit scare towards global markets. Greece could be the catalyst for a general broad-based risk aversion sell-off across all risk assets. Deposit flights in other European countries on the back of Greece would further feed this risk aversion. European assets, with the exception of some, are probably most at risk. The underperformance of European equities versus US equities over the past weeks is a reflection of that.

What have we done in our multi-asset portfolios? As always, our first line of defence against market volatility is diversification. A well-diversified portfolio should suffer less from market volatility as it has very limited risk concentrations. This implies that, for the strategic funds like the Diversified Fund, we haven't changed our well diversified portfolio based on these market developments as it would not fit the strategic nature of these funds. For our more dynamic strategies, we have reduced risks in the portfolio by reducing our equity exposure in two steps – one last week and one on Monday (15 June). To be fair, this risk that reduction isn't solely instigated by Greek risks, it's mainly driven by the risk that the Fed will raise interest rates and the fact that we are more hawkish than the market on the Fed lift-off.

The Fed is as important as Greece

Our research shows that the first rate hike increases the chance of an equity correction (not a disruption of the medium-term view though). The historical average is an 8% correction on the S&P but, given the length of time spent at zero rates, the dependence of all asset prices on extremely low rates and the recent experience of increased bond market volatility, there is a real risk that the effect on markets could be greater than the historic average suggests, even if only in the form of a temporary overshoot. On top of the outright reduction in equities, we continue to use derivatives to further protect portfolios. Much of this had been put in place before the recent market scare and we are now harvesting the rewards of a forward looking risk management approach. Last, we anticipate that a more severe Greek crisis will put further pressure on the euro – either through a loss of confidence in the currency overall or through further monetary loosening by the ECB. We have thus hedged a significant share of our funds' euro exposures.

As mentioned earlier, should there be a deal, we think it's more likely to be a temporary deal with no real resolution of the long-term debt problem for Greece and no unconditional fiscal transfers. This could lead to a relief rally in risk assets, as negative scenarios will be priced out. After that, markets will refocus on the Fed. In our view, the upside scenario for equities from here seems limited as the first Fed hike hangs over the market for the coming three to six months. Our base case is a likely September rate hike for the Fed, with a further increase in December.

Should equity markets correct from here – for example with a Fed scare sparking a 10% sell-off – we would consider buying back the equity exposure we sold earlier, as that kind of move would price in the historical risk attached to a first rate hike. If the markets correct further on pricing in an actual Grexit, the trading strategy is less obvious as it depends on the exact modalities of the crisis and the expected reaction of policy makers – particularly the ECB. However, in case of extreme risk aversion, which is not impossible given the limited liquidity in markets, value would emerge and we would be buying risk assets.

[1]For those not up to speed with their euro zone abbreviations, these are Outright Monetary Transactions, Targeted Longer-Term Refinancing Operations, and the Public Sector Purchase Programme

Key risks

Investing in financial markets exposes investors to risk. These Funds invest in a wide range of asset classes, typically by investing in other funds. While this diversification aims to lower risk, each asset class has risks that may impact the value of the Fund.

Any objective or target will be treated as a target only and should not be considered as an assurance or guarantee of performance of the Fund or any part of it.

Further details (including relevant risk factors and fund specific risks) are available in the Description of Funds document, which can be obtained from your usual LGIM contact or by visiting www.lgim.com/descriptionoffunds