ADVANCE ECONOMIC SPOTLIGHT ON…

GREECE

JUNE 2015

The Background

Greek debt levels came to the world's attention in December 2009 when Fitch downgraded the nation's credit rating. Greece had little government revenue due to widespread tax evasion, and it was revealed that the government had been understating its true debt position for years.

In an effort to avoid bankruptcy, Greece accepted bailouts from the Troika (International Monetary Fund, European Central Bank and European Commission) totalling more than $US264 billion. These were subject to harsh austerity measures that required an overhaul of the Greek economy.

These funds have mostly been used to bail out private creditors rather than build the foundations of a sustainable recovery. The adjustments to the economy have been substantial with the structural fiscal balance and current account balance turning from substantially negative to positive. However unemployment remains high and there are a new signs of an improvement in economic conditions. Reforming the economy and austerity measures have been enormously unpopular within the Greek population resulting in three changes of Government since 2012.

The current situation

This leads us to the present day where Greece is once again running out of money to pay international debts. European officials extended the bailout program in February with the extension finishing on Tuesday – when Greece is due to make a €1.6bn payment to the International Monetary Fund and also replenish emergency funds used to make a previous €750mn payment to the same institution.

Greece was offered a further bail out agreement by the European Union if it agreed to further austerity measures to cut pensions and raise taxes. This agreement also expires on Tuesday but Prime Minister Tsipras instead has called for a referendum on July 5 for the Greek populace to choose whether or not to accept the European Union's proposal and financial aid.

The European Union has announced there will be no extension to the existing program and froze Emergency Liquidity Assistance (ELA) on Friday. Over the weekend, Greek people rushed to ATMs to withdraw their funds and so the Greek government has now closed the domestic equity market for the week and restricted bank ATM withdrawal limits to €60 a day. The Greek banks have also been temporarily closed.

The potential scenarios and implications

Will Greece be able to make the IMF payment on Tuesday?

If yes:

> It looks highly unlikely that Greece will be able to make the IMF payment however if it did, the Troika is likely to continue assistance.

> This would restore some market stability temporarily until the next payment is required from Greece.

If no:

> This would threaten the solvency of Greek banks which would, in turn, suggest losses for German and French banks and the European Central Bank.

> The economic problems in Greece will worsen since the government would be unable to pay pensions. Severe capital controls also mean there is no access to funds for spending or investment by the local populace or tourists.

Will Greece vote in favour of the European Union agreement in the referendum?

If yes:

> This is perhaps the most likely situation given that polls already suggest the Greek population will vote to accept the European Union's agreement rather than leave the Eurozone though the government has been heading in favour of a 'no' vote.

> It will restore stability across European markets but force ongoing challenges in Greece as it seeks to reform its economy, a difficulty already compounded by the temporary bank closures.

> The problems are also pushed down the road into the future, so will arise as a crisis again.

If no:

- This would mean Greece would return to the drachma and leave the Eurozone. There would be short term struggle within Greece but this would allow for the drachma to be substantially devalued as Greece prints money and it would reduce the value of its debt.
- This would then start to assist its recovery however would have serious implications for other European countries awaiting repayment of its debts. The European Central Bank would be severely compromised given its holding of Greek debt, reducing its ability to assist other countries within the Eurozone.

Implications for financial markets

Activity in Greece primarily affects bond, share and currency markets.

Bonds

- Greek bonds have already collapsed but are likely to fall further into distressed/default territory.
- Prices for German bonds may be driven up by a 'flight to safety' out of riskier European assets as investors fear further disruption in the Eurozone.
- Australian bonds may also benefit from movement to safer assets.

Shares

- Uncertainty leads to volatility in the short term and all markets will experience this from risk aversion.
- It is likely there will be a selloff in Greek bank shares along with any other European shares viewed as risky in favour of other areas such as US and Australia.

Currency

- The euro has been relatively resilient to date however investors may move to the US dollar as a safe haven.

How is Advance managing this in the portfolios?

Advance has been monitoring the Greek situation for many years now. Our portfolios have been positioned to manage a range of risks and opportunities in the market, not just Greece. The portfolios are allocated in favour of Australian over international bonds while allocations to international shares favour the US over Europe. These positions also favour a stronger US dollar. Our mandate is the preservation and enhancement of investors' capital and we will continue to manage the portfolios according to this philosophy.

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