Investment Stewardship Guidance

InvestmentPerspectives

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# The Greek Debt Drama and Guidance for Investors

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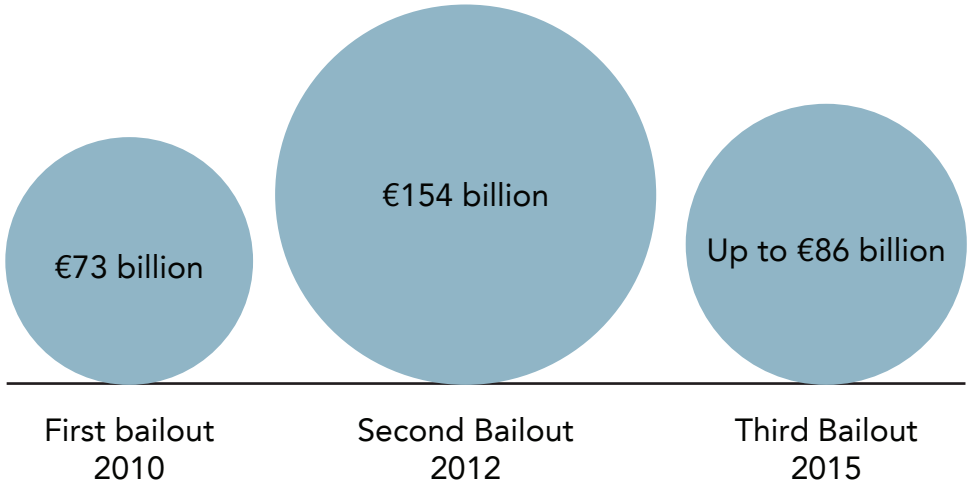
## The Latest Bailout Package

With a history rich in theatre, Greece's starring role in the "Grexit" drama has featured several rounds of inconclusive negotiations, the resignation of a finance minister, the closing of Greek banks, and a missed payment to the IMF. Finally, on July 13, Greece and its creditors reached an agreement on a third rescue package that likely ensures that Greece remains in the Eurozone. Key pension and tax reforms constitute some of the key austerity measures while Greek officials promised to set up a privatized fund by selling $50 billion in state owned assets. The funds will be devoted to the recapitalization of banks as well as debt servicing.

**Exhibit 1:** Greece Bailouts

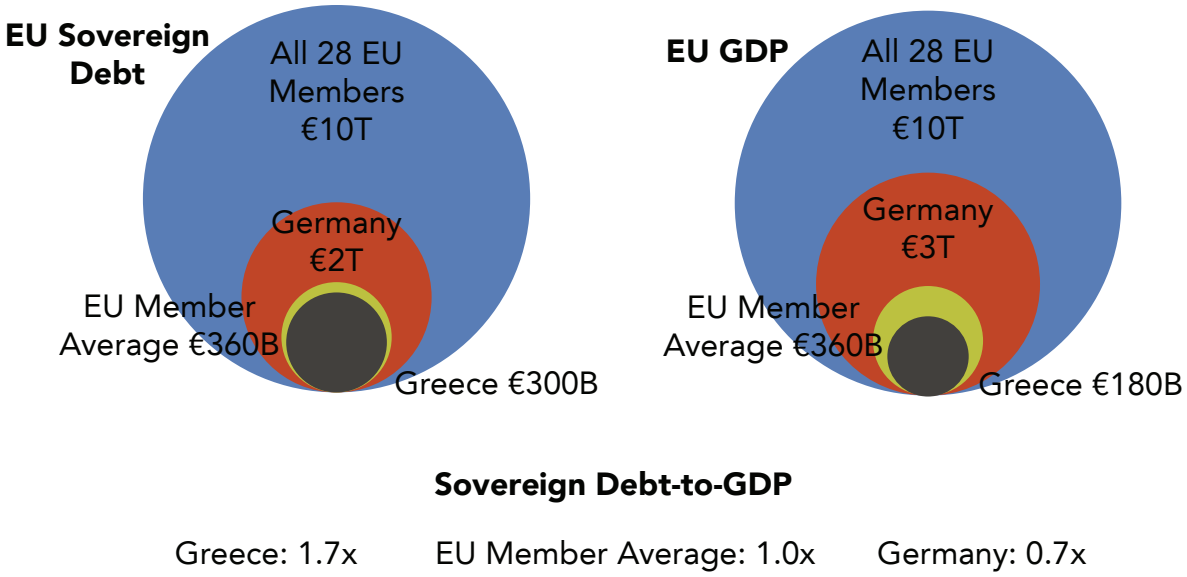



*Source: Wall Street Journal*

More details remain to be negotiated but the Greek parliament approved the fresh austerity measures on July 16. As we enter the final scenes of the current act we offer our readers the charts below to provide a little perspective on Greece.

The left circle below represents the combined sovereign debt of all 28 EU member countries, totaling €10 trillion, shown in the blue. Greece, in the dark gray, owes only €300 billion. The right circle shows the combined EU members' GDP at €10 trillion and Greece with a GDP of only €180 billion. So, while Greece's sovereign debt-to-GDP ratio at 1.7x is much higher than the average EU member's 1.0x or Germany's 0.7x, its size of debt and GDP are minimal compared to the whole EU.

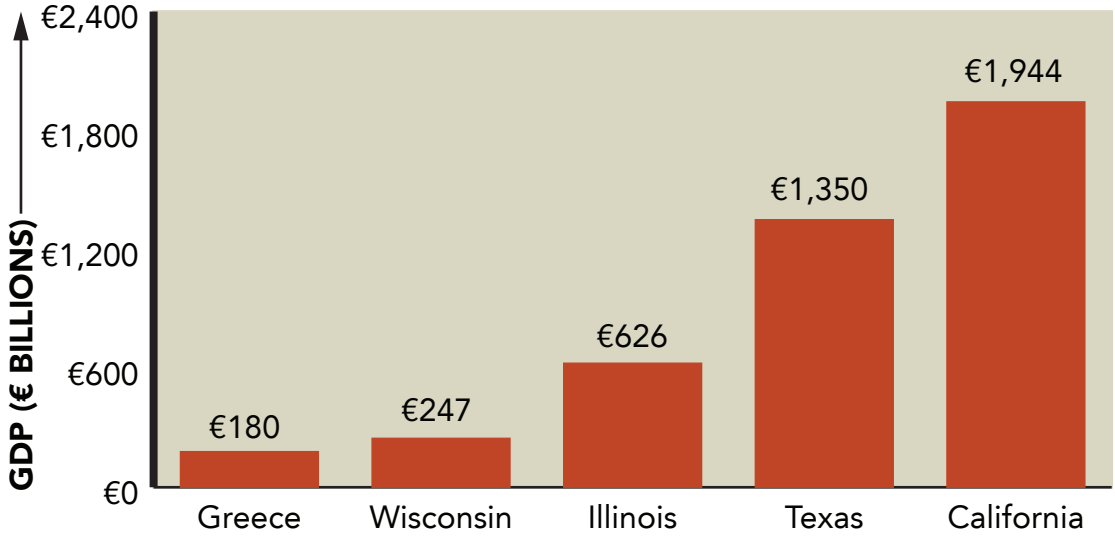
**Exhibit 2:** Putting Greece in Perspective




*Source: Eurostat*

Furthermore, many states within the U.S. have a larger economy than that of Greece. Texas's economy is over seven times bigger while California's is more than eleven times bigger.

**Exhibit 3:** Economy size: Greece vs. Select States




*Source: Eurostat, Federal Reserve*

## Recommendation

Marquette recommends maintaining existing allocations, including those to all U.S. and global fixed income assets as well as all international equities. As shown in the appendix, Greek bonds and equities are not common holdings for the vast majority of international fixed income and equity products, and thus returns are not likely to be impacted by the current debt challenges in Greece.

As for the overall likelihood of a Grexit, moral hazard is an important notion to consider. If Greece extracts concessions, other PIIGS[1] countries will do the same, and in this game theory line of thinking, the ECB may lean towards the lesser evil of allowing the Greek exit to occur. This would be akin to pulling off a Band-Aid quickly—there will be short term pain but ultimately less severity than conceding to Greece and the rest of the PIIGS as well.

How all of this ultimately plays out will depend on the state of the Greek and global economies. Greece pensioners will start receiving IOUs instead of cash payments. Unemployed Greek workers will move to other countries in search of jobs. But the ECB's Quantitative Easing ("QE") will continue to moderate the effect and, given the small magnitude, it is not expected to materially impact the average consumer in the U.S., who collectively constitute the engine that drives the U.S. economy.

Ultimately, a Grexit will challenge the peripherals, elevate volatility in the equity and fixed income markets, drive a sell-off of risk assets, and lead to a weaker Euro. But eventually all of this will be reversed because Greece is a relatively insulated economy. The €300 billion in Greek sovereign debt held by the IMF, ECB and European Commission will likely be written down and recapitalized, which means the strongest economies in Europe such as Germany and France will take a hit. Their debt issuance will slightly increase in order to absorb the reduced principal and interest payments from Greece, but ultimately, Europe - with its continued QE from the ECB and the rest of the world - should be able to sustain such an outcome. Despite all the recent market volatility, economic indicators show gradual improvement in Europe overall and the latest round of Greek debt drama is not expected to have a material impact on international investment returns.

[1] Portugal, Ireland, Italy, Greece, Spain

## Appendix

### Expectations for Fixed Income in a Grexit

Because all $300 billion of Greek sovereign debt is almost entirely held by three supranationals (the IMF, ECB and EC), it is not in the most commonly used global fixed income index (Barclays Global Aggregate), the most commonly used emerging markets debt hard currency index (JPMorgan EMBI) and the most commonly used emerging markets debt local currency index (JPMorgan GBI-EM). Greek sovereign debt is also not held by almost all fixed income managers. Fixed income strategies may have selective investments in Greek corporate debt; however, given the environment, most fixed income strategies have avoided such offerings. What we could expect in a Grexit:

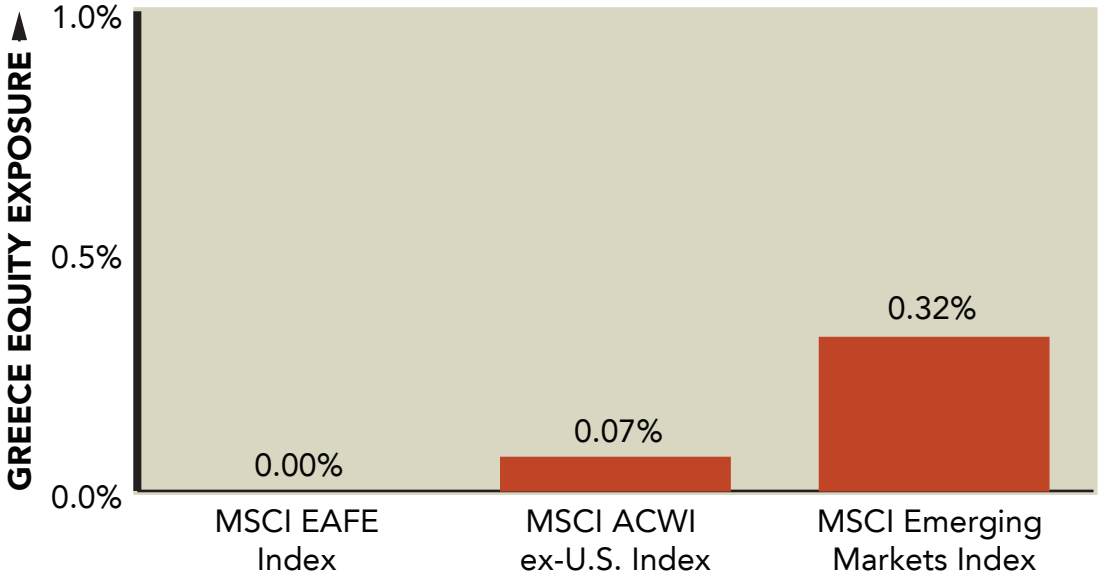
- Spreads will widen in all fixed income sectors, with the most widening found in the other PIIGS countries such as Portugal, Ireland, Italy and Spain because they are the weakest and have the widest spreads currently.
- Volatility will increase.
- The fear will induce safe haven-buying of German bunds and U.S. Treasuries.
- The markets will overreact and present buying opportunities.

### Expectations for International Equities in a Grexit

Greece makes up a very small portion of non-U.S. equity indices. However, the uncertainty surrounding the country's debt has increased the volatility in equity markets. Expect volatility to continue until a resolution is reached on Greece's status in the EU. More specifically:

- The major international equity indices have very little direct exposure to Greece, which is now classified as an emerging market and not included in the developed market index.

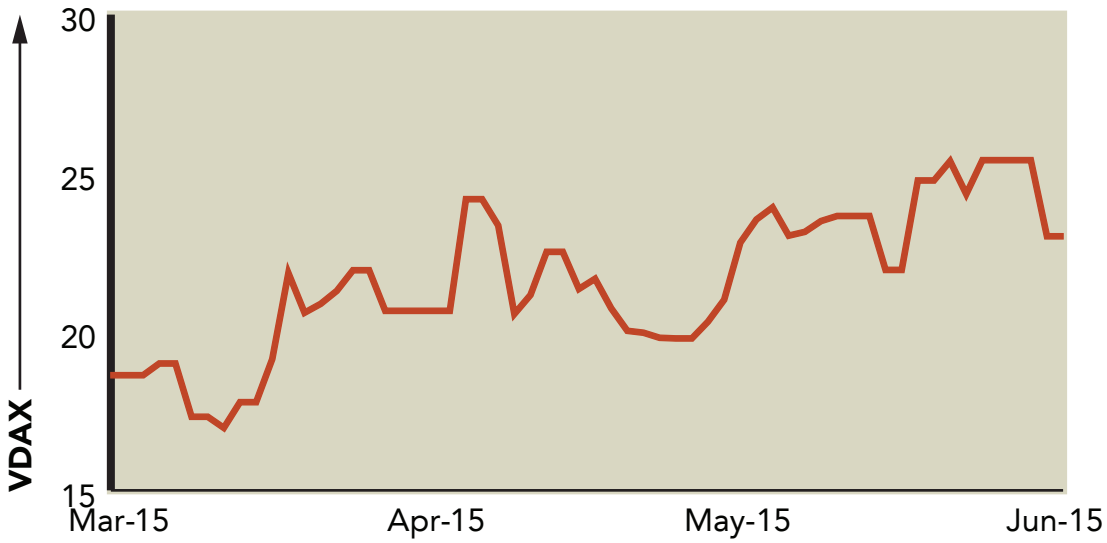
**Exhibit 4:** Greece Equity Exposure in Equity Indices




*Source: Bloomberg*

- Equity volatility has risen and is expected to continue. The VDAX (volatility index of the blue chip stock market index consisting of the 30 major German companies, equivalent of the Dow Jones Industrial Average) has been up 23% since 1Q15.

**Exhibit 5:** Volatility on the Rise




*Source: Bloomberg*

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