INVESTMENT OUTLOOK

Artorius Wealth

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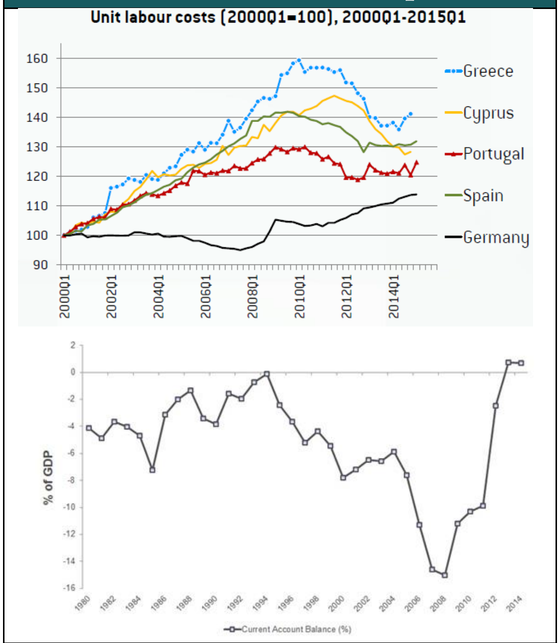
Greece

That Greece cannot afford to pay its debt is probably in no doubt. We outline the best case scenario of the euro area bureaucrats. Even if Greece sustains the 3% primary budget surplus demanded by the troika and in addition, the government brings the real GDP growth rate to a level equivalent to the real interest rate on its debt through a combination of current account surpluses and slower cuts in government spending; it would still take 30 years to bring the Greek's debt levels down to a more reasonable—and perhaps still unsustainable—85% of GDP. We suggest that a lot of ouzo has to be consumed to make it appear a reality.

We think that it is worthwhile to reflect on the economic journey travelled by Greece. The move from current account deficit to surplus reflects the improving competitive position of Greece as unit labour costs have fallen

Unit labour costs have fallen and current account is now in surplus

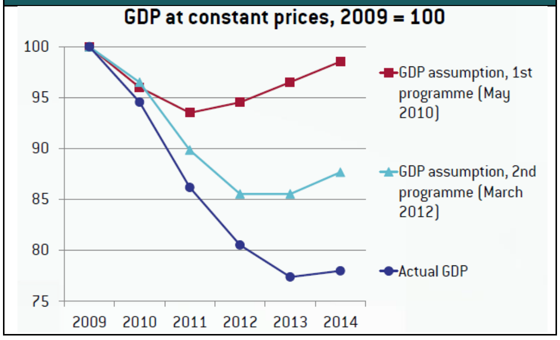


Source: Bruegel, Research Affiliates

Spending restraints have helped push Greece into a primary budget surplus, for the first time since the dubious statistics of the mid-1990s and very early 2000s were published.

However despite the improving trade and government accounts, the economy has shrunk by over 20% since 2009, and is much worse than the projections at previous deals in 2010 and 2012. Most commentators agree that the level of debt to GDP makes debt repayment untenable, and further austerity will hamper Greece's nascent economic recovery.

Greek's GDP has constantly disappointed



Source: Bruegel

Default with or without permission

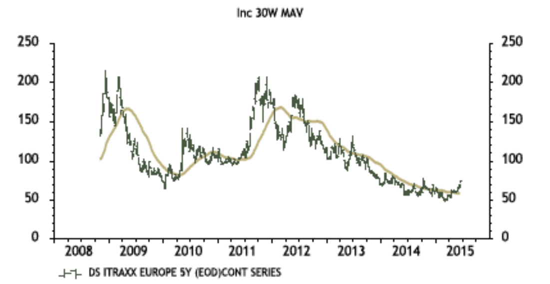
A default is going to take place, and the distinction will be between a default with or without permission of the 'institutions', formerly known as the Troika. Greece needs the funds to make a €1.5bn repayment to the International Monetary Fund by the 30th June. Without an immediate agreement over the weekend on the 20th June, time would be short in order to make arrangements for payment, suggests press reports. Agreements involving a debt restructure would need parliamentary approval from around the Eurozone.

Without an agreement there is a risk of a run on the banks in Greece, where depositors would seek to withdraw their Euros from accounts. If a Greek bank run were to begin, the European Central Bank has a crucial decision to make. It could opt to keep Greek banks on life support by approving emergency central bank loans to local financial institutions or to declare them insolvent and withdraw all assistance. Without the emergency loans from the ECB, Greece's banks would collapse and the only way to restart them would be by creating a new central bank with a new currency. This would be a GREXIT from the Euro, and the IMF calculate that this would result in a cumulative hit on the level of GDP of 12.6% over four years.

View of the market

Given the proximity of a potential Greek default, the markets in the rest of the Euro area remain well supported to date. The cost of insuring euro government debt, as captured by the iTraxx index, has risen slightly but remains low, especially in comparison with 2008 and 2011.

Insurance costs of Euro government debt remains low



Source: Artorius Wealth, ASR

In addition the Euro has rallied of late. This is due to the improving data from the European economy, but highlights alongside the iTraxx backdrop, that the market remains sanguine about the risk of contagion of a Greek default.

Capital controls

An alternative to a GREXIT would be capital controls. These limit the amounts of euros that savers could withdraw, hence limiting the impact on banks' solvency. But once imposed, capital controls are hard to roll back and have a recessionary effect on an economy, as witnessed in Cyprus which imposed controls in March 2013 which lasted for two years, rather longer than the initial week initially outlined by authorities.

Leave or stay

The Greek population overwhelmingly wants to stay in the euro, and the government led by Alexis Tsipras says it does too. The Wall Street Journal says German officials are increasingly resigned to Athens refusing to swallow any meaningful reforms. Without a massive last minute climb down by Greece, Chancellor Merkel will be forced to make the decision that she has avoided all year; either relax Greece's required overhaul or potentially jeopardise European stability. We think that the pain of a GREXIT would want to be avoided by all parties involved in the negotiations.

Our expectation is that the external debt will be defaulted upon and capital controls imposed internally within the Greek banking system. Given that this may trigger concerns over a GREXIT from the Euro and the EU, we think that this would be avoided by the Greeks and the rest of Europe given the economic and social consequences. This may be the most optimistic outcome, although the cost of write-downs for the creditors would be nothing compared to the loss of face for the ECB and other euro area governments.

If a GREXIT were to occur and spread negative reaction in the market, we anticipate that global policy makers would ease policy especially by the ECB, or delay tightening in the case of the Federal Reserve. Hence in either case, a drop of markets on Greek related issues may prove to be an opportunistic entry point for investors.

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