ARTORIUS WEALTH

INVESTMENT OUTLOOK

Artorius Wealth

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Making a drachma out of a crises?

With a resounding *'óchi'* the Greek voters have rejected the deal that was on the table. This is at odds with investor surveys, as reported by Barclays. Post the default on the IMF loan earlier in the week and on-going capital controls, the Greek crises is moving along a pace.

Greek Premier Tsipras maintains that if the Greeks dare vote *óchi* to the European proposal they will have a democratic mandate to ask for, no demand rather, money from their euro-partners without any conditions attached.

Forecasts are challenging, especially about the future, and in the case of a future involving politicians…… A number of factors are crucial in our view. Whilst the Greek government has defaulted on the IMF loan, a payment of €3.5bn to the ECB on the 20th July is seen as pivotal. This includes the prospect of declaring Greece in default and how to deal with the technical bankruptcy in terms of recapitilisation of the ECB's balance sheet.

ECB controls the show

We believe that the ECB is unlikely to take the more drastic step of entirely withdrawing emergency funding on Monday. The opaque Emergency Liquidity Assistance (ELA) has now become the sole source of extra funding. From media reports we know that the cash-value of ELA. is €89bn. The ECB has so far declined to increase the cap on ELA beyond €89bn, and could restrict access in the event of a No vote, possibly in the form of increased haircuts to collateral. This would intensify banks' liquidity crisis.

The last time Athens came this close to "Grexit", in mid-2012, Mario Draghi, the ECB president, decided it was too momentous a decision for unelected central bankers to make, and warned the EU's political leaders they would have to make the ultimate choice on their own.

According to eurozone officials, in July 2012 Mr Draghi told the heads of the European Commission, European Council and eurogroup of finance ministers that they would be asked to guarantee the Greek bonds and other government-backed securities being used by Greek banks in return for ELA. If they demurred, ELA would be pulled and Grexit would ensue.

Earlier on Sunday, ECB Executive Board member Benoit Coeure said the bank was prepared for all outcomes. "The ECB has been clear that if we need to do more we will do more. We will find the necessary instruments," Coeure said at an economics conference in Aix-en-Provence, southern France. "Our will to act in this matter should not be doubted."

Greek debt is unsustainable in the long term, in our view. Greece needs a stimulus, yet a restructuring is politically difficult to sell in creditor countries. An extension deal will not solve the problem: negotiators need to look at other solutions. Making Greek debt sustainable again by restructuring it and bringing it close to 100% of GDP would cost €140bn, or 1.4% of Eurozone GDP.

Royal Bank of Scotland researchers suggest that the minimum direct financial cost for creditors of a Greek exit from the Euro including a default at around €227bn (2.3% of Eurozone GDP). This excludes full contagion costs, geopolitical costs from potentially losing Greece as EU and NATO members, and the impact of creating a Euro-exit precedent.

If the ECB faces a default from Greece the ECB would have to be recapitalized after it writes off the €89 billion it has loaned the Greek banks to keep them liquid. The ECB would need to call for a capital contribution from its shareholders—the governments. Greek banks owe the Target2 bank clearinghouse, a key link in the interbank payment system, an estimated €100 billion. The governments are on the hook to make good that shortfall, too. The cash required to cover these contingencies would have to be funded with new bond sales. Or would the ECB take other steps, which would seem more likely to prevent contagion in the Euro financial system? We believe that the ECB would do whatever it takes to prevent contagion.

Is Grexit possible? Yes

The Lisbon Treaty for the first time explicitly introduced an "exit clause" on the EU membership. A member state wishing to withdraw from the EU must inform the European Council of its intention. A withdrawal agreement between the EU members and the country can be reached by a qualified majority or two years after notification of its intention to withdraw (which means unilateral withdrawal is possible). Whilst the Treaty lacks reference to Euro membership, an inference of the 'exit clause' and ability of a country to withdraw and repudiate the treaties means that a country can withdraw from the Euro, with the ECB paper on this suggesting that withdrawal from the Euro would defacto also indicate withdrawal from the EU.

With that in mind an IMF paper identified eight recent cases where countries suffered a disorderly exit from a fixed currency regime (transition from a fixed to floating regime). GDP growth declined by -6.7pts on average following an exit from a fixed exchange rate regime, currencies depreciated by 40% over 6 months, unemployment and inflation rose substantially.

Parallel universe

The head of the European Parliament, Martin Schulz, told German radio that Greece would have to introduce another currency if the "no" vote wins in Sunday's referendum on an aid-for-reforms deal. "Is Greece still in the euro after this referendum? That is certainly the case, but if they say 'no' they will have to introduce another currency after the referendum because the euro is not available as a means of payment," Schulz told Germany's Deutschlandfunk radio in an interview broadcast on Sunday and taped on Thursday.

Greece has already run an alternative currency system. Greece in 2010 and 2011: Greece itself in the past issued bonds to settle invoices to the Greek state hospitals (Bloomberg). These so-called "pharma-bonds" carried zero-coupon and were denominated in the amount of each approved invoice. They were freely transferrable and could be pledged for cash. The suppliers receiving these bonds could trade them, but at a heavy discount. According to the Linklaters bulletin, IOUs in this form are very unlikely to breach the EU provisions discussed above.

Key dates and conclusions

The key date in the crisis is now July 20, when Greece owes €3.5bn on a bond held by the ECB. If Athens defaults on that bond, it would be almost impossible for the ECB to continue accepting collateral from Greek banks, and the €89bn in emergency liquidity assistance (ELA) would be withdrawn, devastating Greece's banking sector. This may prompt the ECB to turn to Euro area governments for recapitalization to make good the losses on Greek exposure.

Over coming weeks we will see whether Greece and its creditors can work together to reconcile what were two very different interpretations in the run-up to today as to what a "no" outcome means, and do so very quickly and effectively.

The consequences of a Grexit or default are not 'priced into' currencies or equity markets, in our view. However the actual path to Grexit is unclear even though that appears to be the path stepped onto by the *óchi'* vote.

Over the summer we expect market reaction beyond the initial nervous drop to the vote surprise to be shaped by policy from the ECB. If the ECB provide further stimulus, we anticipate weakening of the Euro, but in turn support the european equity markets..

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