



Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

June 2015

Greece in default (?)

Over the weekend 27-28th June, the Greek Prime minister, Alexis Tsipras decided to end negotiations with the Troika and instead declared his intention to let the Greek people decide whether the Greek State should accede to the creditors' proposal in its current form.

Given that the earliest a referendum on the question can be held is 5th July, Greece is therefore effectively in default. This is because for liquidity reasons, Greece has been allowed to roll all of its capital repayments and interest payments, into one single payment – the deadline for which is the end of June. Now the first payment (if it happens at all) can only occur after the referendum, (assuming that it had been feasible before it!) Apparently, opinion polls show that a majority of Greeks will accept the creditors' negotiating proposals, but it is still very unclear what's going to happen after 5th July.

Since Syriza's election victory in January, the situation in Greece has grown increasingly worse. An embryonic recovery, based on the partial implementation of a number of necessary reforms, has gradually been stifled by the uncertainty created by Syriza around the debt situation. In recent weeks, uncertainty in Greece has had a negative impact on stock markets – particularly those of Europe. What we can expect going forward?

Greece's gross debt at present amounts to about 175% of GDP, and it is gradually becoming clear that the country cannot - and will not - serve this debt burden. The debt has spiralled out of control because Greece's costs have risen significantly in comparison with other European countries. Since Greece already lacked competitiveness at the time of joining the euro, the situation has now worsened dramatically. Another indication of Greece's economic ineptitude is the fact that the trade balance has been negative for at least 25 years (which is as far back as we can find data).

The only way competitiveness can be restored is if costs can be lowered compared to other European countries. This can be done in only two ways: an internal devaluation (by keeping the euro and accepting that prices will fall dramatically) or an external devaluation (represented by the transition to a new currency, which can then be permitted to drop in value against the euro).

If the Greeks decide to keep the euro, they will in all probability experience deflation for several years, because their competitiveness is so poor at the current prices. This will make debt even more difficult to repay. If they instead choose to go from euro into another currency and then devalue, they will quickly re-establish their competitiveness, but they will necessarily go bankrupt because the euro-denominated debt then becomes even greater and more difficult to repay.

The Greek government overspending has been financed by debt, while the accumulated trade deficit has been financed through the so-called TARGET2 system, which is a clearing system for national, European central banks' claims on each other. Since 2008, the Northern European euro countries (especially Germany) have accumulated massive debts in TARGET2; while the Southern European countries (especially Italy and Spain - but also Greece) reverse owe the debt due to the northern European countries as a result of their large trade deficits and capital flight to the safer northern Europe.

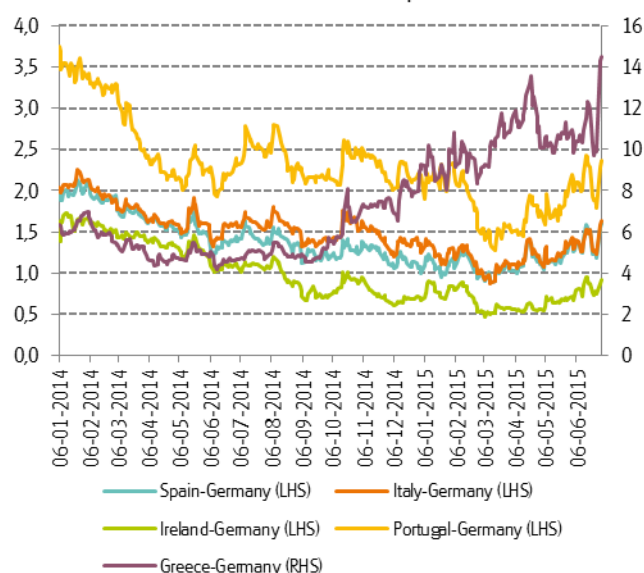
In recent weeks, the lack of results in negotiations between the Troika (IMF, ECB and EU) and Greece has indicated - with a probability bordering on certainty - that a bankruptcy is approaching. A restructuring of Greek debt will probably mean that foreign creditors receive only half of their nominal assets back. In addition, Germany in particular will be hit hard with a loss via TARGET2.

The Greek government issued gross debt to the value of 175% of GDP, or about 318 billion. euros. In addition, claims on the Bank of Greece through the TARGET 2 represent a further 99 billion. euros. The maximum loss, creditors may be exposed to therefore amounts to more than 400 billion euros. Part of the Greek debt is already held by domestic investors (especially by the banking system), so in effect it will be less. Furthermore, in the history of national bankruptcies, it is not the practice to write off debts in full, as doing so would send an intolerable signal to investors and thus impede a return to national borrowing via debt markets.

European interest

Greek GDP represents less than 2% of Eurozone GDP, so the problem should be insignificant for the European debt markets, which - until now - have responded to Syriza's intransigence with a shrug. So far, we have seen only a moderate widening of yield spreads against German government debt in the other southern European countries, and this development can also be explained by the general interest rate increases we have seen since March.

Figure 1 – Interest rate spreads
in Southern Europe



Not only is the European economy entering a recovery, but the European banking system is also clearly far better capitalized at the present time than it was during the euro crisis of 2011. This means that losses from a "haircut" on Greek debt could be absorbed much more easily. Furthermore, we can expect to see an improving development over coming quar-

ters. It was undoubtedly a retrograde step that Syriza was elected, but it was a situation that was to be expected.

Greek interest rates have, of course, responded by rising sharply since the weekend. Interest rates on two-year government bonds rose by 17 percentage-points to over 38%. The interest rate on 10-year government bonds rose by almost 4 percentage-points to 14.7%. The other, European countries – especially the "secure" Northern ones – have seen falling interest rates, while Portugal, Spain, Ireland and Italy have seen moderate increases.

If we take a moment to step back and consider the situation without interference from Greece's background noise, we see that from April to the end of May, Global bond markets were marked by a relatively large shift in interest rate expectations and steeper interest rate curves. This is usually a good indicator of future growth prospects, and as I wrote in last month's report, I expect that interest rates will continue to rise over the summer, as the European economies in particular improve.

Specifically, it is worth noting that long-term inflation expectations are still relatively low and certainly have not increased to the same extent as the general level of interest rates. In other words, there is still a possibility that long-term interest rates could rise by a further 20-30 basis points — only as a result of a shift in inflation expectations.

European shares

On Monday 29th June, stock markets in Europe reacted with relatively sharp declines of 3-5%, although the reaction became more moderate over the course of the day. My assessment is that this is a reaction to a European economy that is judged by the market as being able to handle a Greek bankruptcy. It is not surprising that the stock markets fall immediately after this kind of adverse publicity..

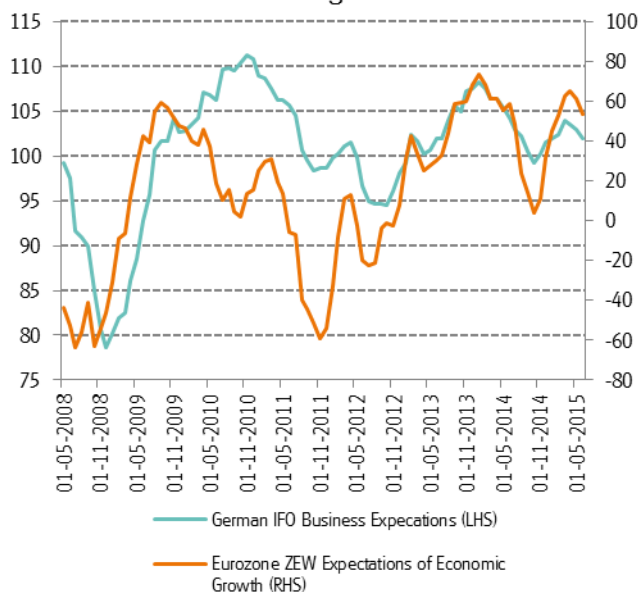
Since the stock market – like all other markets – is forward-looking, we can derive a certain confidence from the fact that its reactions (and the same goes for the fixed income market) have not been greater. Furthermore, the stock market has had quite a long time to get used to the idea of a restructuring of Greek debt.

The outlook for European equities still looks reasonable. Surplus liquidity (i.e. the difference between the growth in the real money supply and GDP growth) is increasing, according to recent figures for growth in the money supply. In addition, the IFO figures from Germany remain at a quite high level

(102), and retail trade is flourishing trade, with annual growth rates of 2.2% – something not seen since 2007.

In addition, the ECB (with the events in Greece in mind) are likely to keep a firm hand on the market. In practice, this will mean that the spreads between the southern European countries and Germany must not grow too wide. Thus, the ECB will help to keep the market supplied with ample liquidity for some time to come.

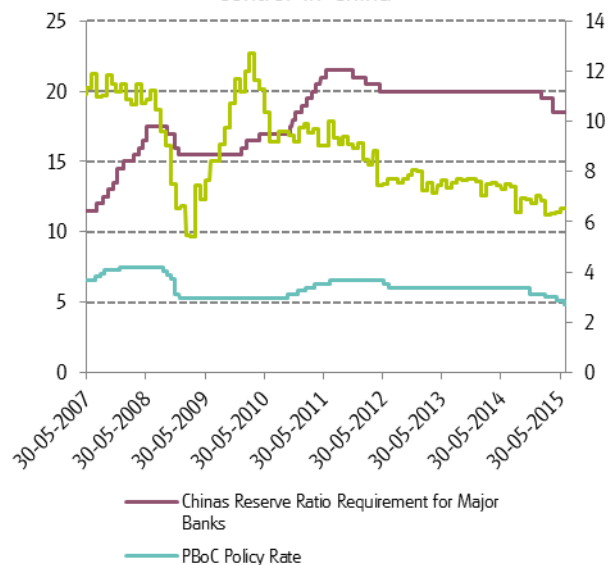
Figure 2 - Surveys for expected Euzone growth



Other shares

In the United States, the economy improved substantially according to the leading indicators of industrial production, which means that we will probably see stronger numbers for ISM manufacturing in future. It would appear that service industries have not been hit by the minor slowdown we saw in Q1-Q2 of 2015. Actually, it appears (Figure 1) that the United States will see a comeback as we head towards 2016. This should help U.S. stocks - despite the prospects for a tightening of the still very accommodative monetary policy.

Figure 3 – Key figures political-economical control in China



In China, the stock bubble burst, giving China's small investors a hard lesson in the fact that blind speculation does not pay in the long run. The latest figures for "account openings" in China (i.e. stock market trading accounts for small investors) still show an increasing trend from March to the end of April, but when we get the new figures for the end of June, they will almost certainly reveal a declining interest in the stock market. In any event, the Shanghai Composite has fallen by almost 22% in less than three weeks.

It seems that Chinese equity investors (or speculators) have not, after all, been able to ignore weak economic development. The PBoC (Chinese central bank) has just lowered interest rates, but it is not enough to prevent a further drop in the stock market. The reason is that the latest GDP growth, according to Bloomberg's monthly GDP indicator, has now fallen to an unprecedented low of 6.55% (unofficial figure), and the downward trend is still unbroken. In addition, Chinese monetary policy – despite low interest rates – still pretty tight, because the RRR (Reserve Ratio Requirement) for the banking system is very high. Furthermore, the real value of the renminbi is also a drag on the economy and taken over the last few months, we have observed a fairly large capital outflow, which is also tightening financing conditions.

It is my expectation that Chinese equities will fall further, but that the Chinese authorities are on hand with a greater easing of monetary policy, which, in the longer term it will help to buoy up both Chinese equities and real estate. However, I do not expect a stabilization of the stock market until the

autumn or after/if the sharp downward momentum continues for a few weeks yet.

Emerging Markets equities are affected by the weakness of the stock markets in Brazil and China, but the other EM-country markets actually look set to be able to benefit from the resurgence of European growth in both consumption and production. The indicators for industrial production are still positive for Emerging Markets as a whole, which tends to support the stock markets going forward.

Blue Block's victory in Denmark: what does it mean?

After Lars Løkke Rasmussen and Blue Block's victory in the Danish elections, we have now had a chance to look more closely at the Government's program. Due to the election result, the power relationships between the blue parties', and the distribution of seats, it does not appear as if we should expect anything remarkable from the new Government. For a start it is a minority Government made up of a number of divergent factions with a slender parliamentary majority, elected on an extremely narrow mandate.

Thus, we see relatively few, growth-promoting measures outlined in the Government program, and their implementation is also not guaranteed. As I wrote in last month's report, one cannot expect substantial changes in assumptions for Danish investors.

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