1 July 2015

Eurozone Volatility

Greece's debt issues resurface…

The end to the 2015 financial year has been marred by the recurring issue of Greece defaulting on its debt obligations and the question of a potential exit from the Eurozone.

Over the weekend talks between Greece and its European creditors fell apart after Greece's Prime Minister Alexis Tsipras announced a snap referendum on bailout conditions put to Greece. The referendum, which is to be held on 5th July, will let the people of Greece vote on whether they are willing to accept the terms being put forward under the bailout by International Monetary Fund (IMF), European Union (EU) and European Central Bank (ECB). Some of the measures put forward include increases in taxes and cuts to pension. Many are looking at the referendum more as a proxy vote on whether Greece wants to remain within the Eurozone.

The announcement of the referendum was days before Greece was scheduled to repay €1.6 billion to the IMF on Tuesday 30 June, which also coincided with the expiration of its bailout program. Despite Greece's final hour request, it appears Eurozone finance ministers have rejected its request to extend Greece's current bailout program. IMF announced this morning that Greece did fail to make the payment and it is now considering Greece's request *"for a delay in payment".* The Greek government has shut down all domestic banks until after the referendum has taken place in order to avoid its banks from collapsing. Some provisions around ATM withdraws are in place.

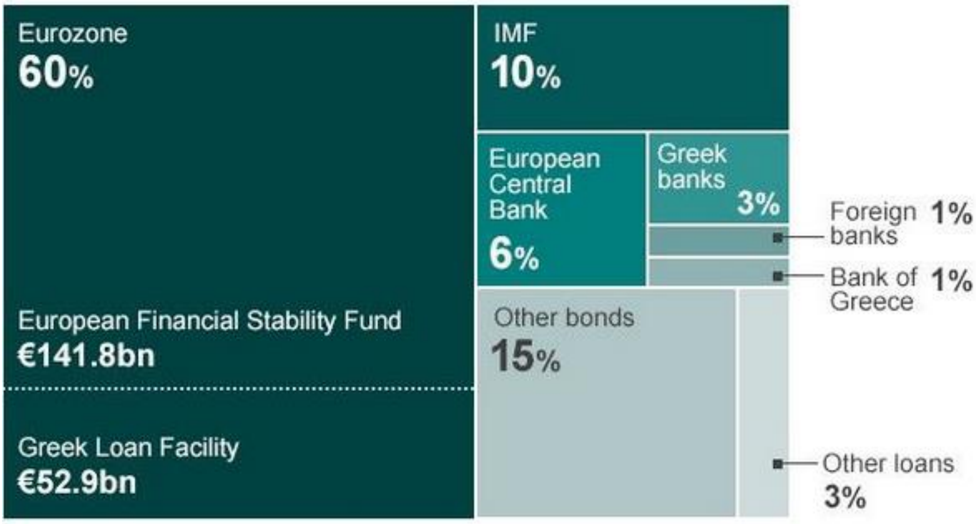
What does a missed payment mean? Under the terms of its bailout, if Greece missed its payment to IMF the Eurozone could immediately request all of its loans (more than €180 billion) to be repaid. This is unlikely to happen in our view as Greece would not be in a position to repay such an amount.

Our conclusion upfront. While the ongoing issues in Greece are fatiguing most investors, we believe the contagion from Greece defaulting on its debt obligations and potentially exiting the Eurozone block is diminishing in significance. While any form of exit will not be smooth for global markets, Eurozone is better placed for such a scenario now compared to when Greece first emerged as a problem child. Our thinking is based on four key factors: **(1)** Most European banks and non-European banks have significantly reduced their exposure to Greece since 2011. Therefore, we do not expect any significant stress on balance sheets of financial institutions to emerge. **(2)** The Eurozone fundamentals continue to show positive signs of recovery, despite the headlines being dominated by Greece issues. The positive momentum in real GDP and PMI growth reported in recent quarters should begin to drive earnings growth for companies in the region, a positive catalyst for financial markets. Additionally, Greece is increasingly becoming a small contributor to Eurozone's overall GDP (Greece's share currently at approximately 1.8%). With other economies improving – Germany, France and other peripheries – the issues of Greece should eventually take a backseat to the broader economic recovery in the Eurozone. **(3)** ECB's Chairman Mario Draghi's promise of "whatever it takes" should provide a liquidity buffer for peripheral economies should a Greek exit materialise. The ECB launched a government bond-buying programme which is expected to provide €60 billion a month into the economy until September 2016. **(4)** Despite the recent breakdown in negotiations, there remains a willingness from European leaders to keep Greece part of the Eurozone. If recent polls are also an indication, then majority of the Greek population also want to remain part of the Eurozone.

The markets had an adverse reaction to the news over the weekend, however appear to have had a more benign response to Greece missing its IMF payment. The longevity of any volatility in the financial markets will depend on how long the current talks drag out and whether they deteriorate to a point of Greece existing the Eurozone. Otherwise, we expect equities to find support on the imminent announcement of a revised bailout program with Greece and the ongoing improvement in economic performance of the remaining Eurozone economies.

Who is exposed to Greek Debt? The graph below shows the breakdown of Greece's creditors, with Eurozone, IMF and ECB making up 76% of this debt – that is taxpayer funds. Since 2011, European banks and foreign banks have significantly reduced their exposure to Greek debt. While a default on Greek debt will be a significant event for the Eurozone taxpayers, there would be little impact by way of balance sheet pressure on other financial institutions.

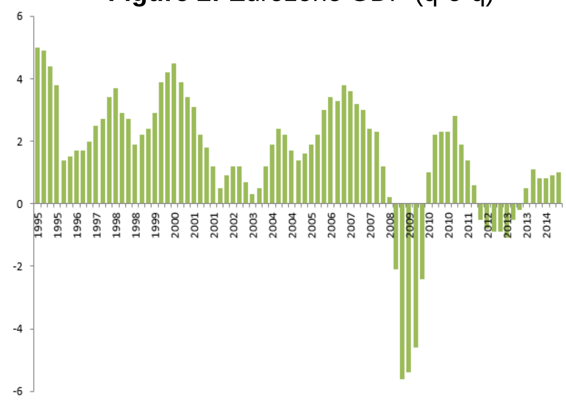
Figure 1: Greek Debt in breakdown - €323 billion



Source: Open Europe, BBC

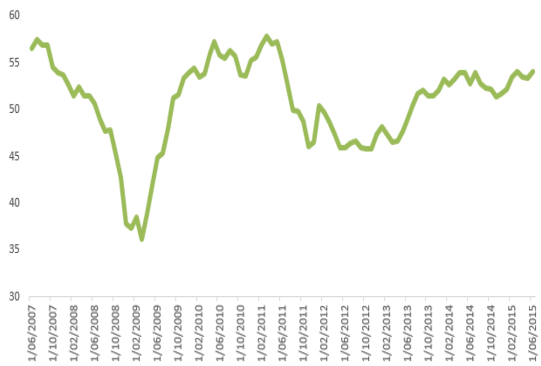
Eurozone macro-economic conditions. Eurozone fundamentals continue to show positive signs of recovery, despite the headlines being dominated by Greece issues. Figure 2 & 3 illustrates the positive momentum in real GDP and PMI growth reported in recent quarters. The importance of this point is that Greece is increasingly becoming a small contributor to Eurozone's overall GDP (currently around 1.8%). With other economies improving – Germany, France and other peripheries – the issues of Greece should eventually take a backseat to the broader economic recovery in the Eurozone.

Figure 2: Eurozone GDP (q-o-q)



Source: Bloomberg

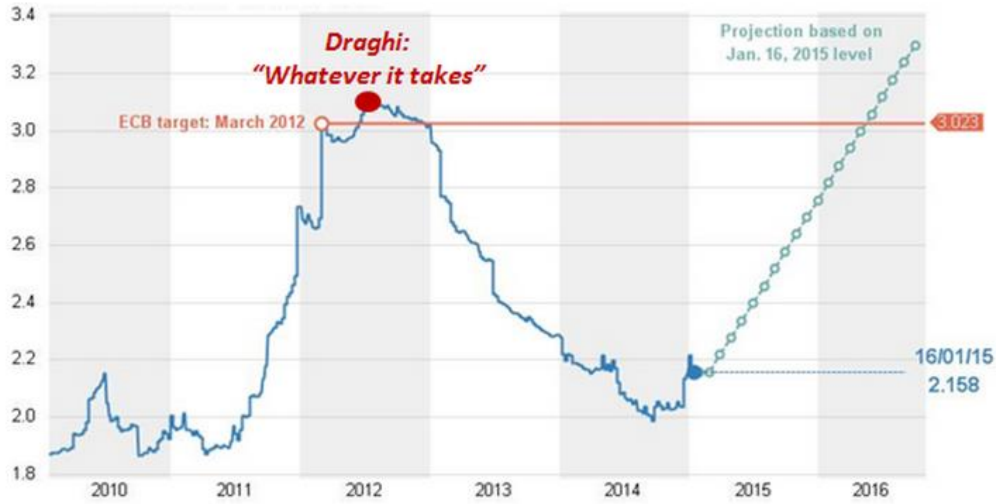
Figure 3: Eurozone PMI



Source: Bloomberg

European Central Bank (ECB) to flex balance sheet power. The ECB launched a government bond-buying programme which is expected to provide €60 billion a month into the economy until September 2016. ECB's QE program is the key backstop to avoid any contagion across peripheral markets in the event of a full Greece default and exit from the Eurozone. Figure 4 highlights how the current QE program will see ECB's balance sheet expand beyond €3.2 trillion by the end of September 2016.

Figure 4: ECB Balance Sheet (in trillions of euros)



Source: Thomson Reuters Datastream

Greeks want to stay with the Eurozone (source: GPO). The majority of Greeks wish to stay in the Eurozone, according to a recent poll conducted in June 2015 by GPO. Key points:

- **69.7% of Greeks want to stay in the euro** and 28.9% are in favor of a national currency, while 68.5 would vote in favor of the European common currency and 27.6% would choose the drachma if the government were to hold a referendum.

- When asked if they would prefer to stay in the Eurozone even if that requires that the government implements harsh austerity measures, 56.2% of participants said they would choose the euro. To the same question, 35.4% of Greeks said they would prefer that the country goes bankrupt and exits the Eurozone.

- Regarding the European Union, **57.5% of participants believe that the EU does not cater to Greek interests but Greece should remain a member**, otherwise we will be isolated. Only 18.8% believe that the European Union means progress and we should remain a member, while 21.3% believe that we should leave the union

Equities Analyst – Zach Riaz

Important Information

This report is prepared by Bridges Financial Services Pty Limited ABN 60 003 474 977 AFSL 240837 (Bridges). Bridges is an ASX Market Participant and part of the IOOF group of companies.

Bridges and/or its associated entities, directors and/or its employees may have a material interest in, and may earn brokerage from, any securities or other financial products referred to in this document, or may provide services to the company referred to in this report. The document is not available for distribution outside Australia and may not be passed on to any third person without the prior written consent of Bridges. Bridges and associated persons (including persons from whom information in this report is sourced) may do business or seek to do business with companies covered in its research reports. As a result, investors should be aware that the firms or other such persons may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as a single factor in making an investment decision.

The document is current as at the date of issue but may be superseded by future publications. You can confirm the currency of this document by checking the intranet site (links below).

The information contained in this report is for the sole use of advisers and clients of AFSL entities authorised by Bridges in writing. This report may be used on the express condition that you have obtained a copy of the Bridges Financial Services Guide (FSG) from the website www.bridges.com.au/fsg

Disclaimer: The information in this report is general advice only and does not take into account the financial circumstances, needs and objectives of any particular investor. Before acting on the advice contained in this document, you should assess your own circumstances or seek advice from a financial adviser. Where applicable, you should obtain and consider a copy of the Product Disclosure Statement, prospectus or other disclosure material relevant to the financial product before making a decision to acquire a financial product. It is important to note that investments may go up and down and past performance is not an indicator of future performance.

The contents of this report should not be disclosed, in whole or in part, to any other party without the prior consent of Bridges. To the extent permitted by the law, Bridges and its associated entities are not liable for any loss or damage arising from, or in relation to, the contents of this report.

For summary information about the qualifications and experience of the Bridges research service or the coverage, criteria, methodology and spread of ratings, please visit the intranet site (links below).

http://www.consultum.com.au/
https://intranet.bridges.com.au/