Economic Insight

Eurozone Update – After the referendum

The Greek referendum saw a clear rejection of creditor bail-out conditions. Negotiations are now expected to recommence and may start to focus more on debt re-structuring as the country continues to suffer under capital controls. Risk of 'exit contagion' is higher after the vote, which could have a notable effect on the politics of the situation. As before, the main risk from Greece is through the spread of negative sentiment to markets not directly affected – particularly given the volatility we're currently seeing in China.

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Last Friday we released a note covering the run up to the referendum and some of the major considerations around what could happen afterwards. In the event, the referendum delivered a very clear 'no' vote putting the Greek Government and its creditors onto yet another collision path. Markets reacted negatively with equities and the euro falling, although the magnitude of these movements has been relatively subdued.

This likely reflects both the fact that markets have already had time to account for the risk of a 'no' vote, and also the acknowledgement that any deal or Grexit is still some way off. After all, the vote is political and does not trigger any mechanism in itself, but rather shifts the perceived probabilities of a broad array of potential outcomes. As a result, rather than a sharp sell-off we're seeing investors slowly throttling back their risk exposure.

Will we see Grexit?

Of course the 'no' vote does increase the likelihood of a Grexit, and bond markets appear to be discounting in some sort of default – but with a reasonable recovery rate (i.e. the bonds aren't repaid in full, but you could still get back around 50% of the bond value). Negotiations are now expected to resume, though the focus could move on to debt relief as the IMF and French officials have suggested.

It remains to be seen how cooperative other creditor parties will be to such a change of tack. What is clear is that the political stakes across the rest of Europe are now higher given the risk that 'exit contagion' spreads under the auspice of 'the will of the people'. However, any such effect on bond markets will most likely be contained by the ECB's previously mentioned contagion defences.

Capital controls remain

It also seems likely that capital controls will remain in force for some time – similar controls in Cyprus remained in place for two years – and it is questionable when banks will be able to re-open fully. The liquidity and solvency of the Greek banking system remains extremely delicate, and it is the most visible manifestation of how acute the situation is becoming. Without further support the Government may be forced to act, perhaps through the issue of IOUs (arguably the first stage of a Grexit since this would effectively be a new currency). Another uncomfortable but possible route to the re-capitalisation of the banks would be depositor bail-ins (wiping out a part of depositors' deposits).

The next step for Greece

The pressure is on in Greece and time is running out – but it hasn't quite run out yet, and despite the 'no' vote a deal is still possible. In theory, this could leave Greece in the Eurozone with a functioning economy and banking system. It is for the politicians to decide, and there has already been one high-profile casualty – the Greek Finance Minister Yanis Varoufakis – who apparently sacrificed himself for the good of the negotiations after the referendum result. In Greece, eyes are now on the pro-European President, Prokopis Pavlopoulos, who could potentially trigger further elections if he resigns from his post. Unfortunately plenty of political intrigue remains.

Our investment outlook

From an investment point of view, I would reiterate that the direct effect of Grexit remains very small (if it happens). However our main concern is market sentiment – which could drive volatility and weakness regardless of fundamental considerations, particularly given the volatility we're seeing in China and the weak liquidity in many markets. In our managed portfolios we continue to take a cautious stance and focus on the more liquid markets, although short-term periods of weakness can also present opportunities to top up exposures in our preferred markets.

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