AQUILA

Flash

Greece’s problems have not gone away

With Brussels adopting a tough line, Greece’s government was by mid-July forced into a U-turn, having to request the Eurozone’s ESM facility formally for a fresh bailout package. Once Brussels gave the green light to a bridging loan and negotiations on a third bailout package, markets seemed to regard the latest Greek drama as over. But we are almost certain that within the next three years a fresh Greek debt crisis will emerge. The show of force that keeps Greece in the Eurozone by hook or by crook goes against the natural order of an economic adjustment process. Once again the future is being mortgaged to solve the problems of the present. That said, the manipulation of markets looks set to continue and interest rates will remain kept at extraordinarily low levels. With this background, we maintain our overweight stance in equities. Moreover, equities as “real” assets are better placed to withstand future crises than “nominal” assets.

Despite brave talk and posturing the newish Greek government was forced into a U-turn.

On June 27 2015 the Greek Prime Minister Alexis Tsipras withdrew from negotiations over a fresh aid package for Greece and announced a referendum giving the Greek people their say on whether to accept the offer from Brussels. After the vote on July 5 produced a clear “no”, Brussels reacted by playing hardball, forcing the Greek government into a U-turn in that it had to ask formally for a fresh bailout package. Once the Greek parliament had approved a much more extensive program of structural reform than the electorate had rejected on July 5, Europe’s politicians gave the green light to negotiations on a fresh bailout package and agreed a 7bn. euro bridging loan. At the same time, the ECB began to help the Greek banks out of their desperate liquidity situation. At that point investors seemed to regard the latest Greek crisis as being over. Subsequently, on August 19, the German and Dutch parliaments voted to approve what had been negotiated, allowing Greece’s third bailout package to be disbursed.

The IMF has serious doubts that Greece can service her debts.

In a recently published study the IMF suggests that, given current arrangements, Greece’s indebtedness will peak at 200% of GDP, rather than the 180% forecast previously. For 2022, the IMF is no longer forecasting a debt to GDP ratio of 142% but rather 170%. This is the background to IMF doubts as to the sustainability of Greek debt. The obvious solutions are a cut in the value of loans to be repaid or a further substantial postponement of the date at which they have to be repaid. The IMF has suggested a loan extension of 30 years to 2053. Given the very low coupons that already apply to Greek debt, this proposal is not far off a perpetual loan at a zero interest rate. Even this may not be enough as the IMF also casts doubt on the macro assumptions underlying recent negotiations. Thus Greece is assumed to run a primary government surplus in coming decades of 3.5% of GDP. With respect to productivity growth, Greece should move from bottom place in the Eurozone to becoming one of the leaders. At the same time, it is assumed she will achieve one of the highest labor market participation rates in the currency union.

All this begs the question: Why should a third bailout package work when the previous two did not?

With the first two bailout packages having already wasted 240bn. euros, one wonders just why a third package – amounting an additional 86bn. euros over three years – should be successful. Certainly, the circumstances – as outlined above – have not become any more favorable. Although the facts, as well as common sense, seem to speak against it, Brussels seems determined to throw a lot more good money after bad.

Greece is bankrupt.

Greece is clearly bankrupt. Those arguing that reforms will justify a further aid package certainly understand that, while the Greek parliament may approve a package of reforms, this does not mean that those approved reforms will be implemented. Reforms first have to be put into laws which then have to be interpreted and enforced. We doubt that Greece can make recently approved reforms effective within the next three years. She will not become reform-oriented overnight. Thus we expect that, within three years at the latest, there will be a repeat of the Greek crisis which has just passed.

Grexit – or a Greek exit from the Eurozone – would have been best for all concerned.

Greece's being kept in the Eurozone by hook or by crook is neither good for Greece nor for the rest of Europe. On the one hand a Greek exit from the Eurozone would – mainly through the devaluation of the Greek currency – deliver the adjustment necessary for that country to regain her competitiveness. On the other, the removal of her weakest member would have made the Eurozone more homogenous and hence stronger. Geo-political problems arising from a Grexit might still be solved by allowing Greece to remain a non-Eurozone member of the EU.

The EU's display of power politics has undermined the normal process of economic adjustment.

The EU's dealings with Greece have suppressed the process of economic adjustment. A bankrupt country has not been allowed to declare bankruptcy so that her creditors do not have to recognize their losses. This way of doing things is part of a pattern whereby governments and central banks adopt policies which aim to manipulate the markets. Thus the economic cycle is suppressed as policy-makers repeatedly aim to stave-off any impending recession. Financial markets are flooded with liquidity which makes the financing of massive government debts easier. In the end, today's problems are simply pushed out into the future.

With problems left to pile up, their overall extent becomes ever more threatening.

The probability is increasing that the problems now being put off for another day will eventually overwhelm the governments and central banks which now focus on temporizing and delay. The process whereby economic balance is restored can, once it starts, be extremely violent. In such a scenario, no asset class is likely to do well and investors will not be able to hide. But this particular story is not yet so far advanced. Market manipulation looks set to continue and, for the time being, it will have the desired positive effects on the markets. Thus we remain overweight in equities. Underpinning our investment stance is our view that equities, as real assets, are more likely to do better in a future crisis than are nominal assets.

Aquila & Co. AG, 19. August 2015