Commentary
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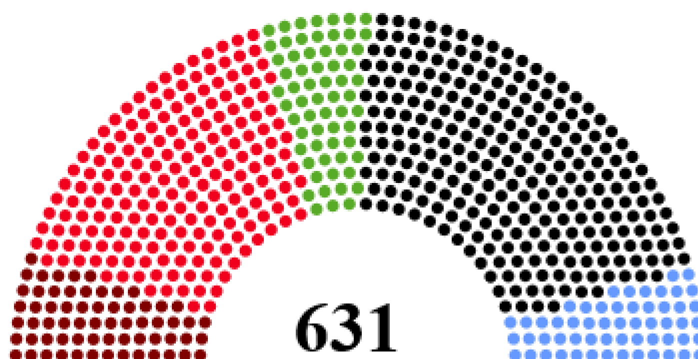
Thoughts on the Greek debt crisis

Eric Bushell, CFA
CIO, Senior Vice-President, Portfolio Management

German politics matter

German society remains divided on the issue of further debt relief for Greece. Despite the refusal by the CSU party (right wing) and some CDU (center right) members to support a third Greek bailout, the Left, Greens and the bulk of the SPD (center left) are still willing to make a deal. Overall, the majority of the ruling coalition and the opposition would support a proposal by the Chancellor (see Figure 1, below). Their willingness to bargain is in spite of the fact that German public opinion turned, out of frustration, against Greece this spring. The dominant political factor is that Germany is a reluctant hegemon and refuses be the nation that puts the European project at risk, which a Greek exit would indeed do. German Finance Minister Schauble talks tough, but Chancellor Merkel prefers the safety of an "amend and extend" approach whenever possible. For the past five years that was possible, today Germans are taking keen interest in the Greek bailout, raising the political risk for Merkel, the calculating Chancellor. If a new deal is struck, expect it to conveniently extend well beyond the next French national elections in April 2017 and the German Federal elections in October 2017.

Figure 1: Bundestag seats by party



Government (504)

- CDU (Christlich Demokratische Union Deutschlands) (255) Black
- SPD (Sozialdemokratische Partei Deutschlands) (193) Red
- CSU (Christlich-Soziale Union in Bayern) (56) Blue

Opposition Parties

- The Left (Die Linke) (64) Rust
- Alliance '90/The Greens (Bündnis 90/Die Grünen) Green

Regional politics matter
Contagion risks are important, but they have become more political than financial in nature. Governments in Lisbon and Madrid fear populist leftist parties taking inspiration from Greece's governing Syriza party. Having undertaken difficult reforms with heavy social costs, these southern European governments are insisting that Germany does not bail the Greeks out without true reform commitments. Overall, there appears to be agreement among European Union members for striking a strict deal, with the exception of France. As for financial contagion, the European Central Bank's quantitative easing program and bank stress tests have made these risks more manageable, with many financial exposures and linkages having been reduced. The movement in peripheral government spreads has been subdued thus far. However, if fear strikes, emotions can and will take charge.

Greek referendum
The surprising "No" victory in Sunday's referendum has Greek Prime Minister Tsipras aiming to restart negotiations with new leverage over Europe. He is promising immediate results and the opening of banks – but this likely won't happen. The European leadership is unmoved and is sticking to its guns. Brussels will continue to insist on important Greek concessions and I expect that officials will drag their feet on the resumption of talks. Delay gives the advantage to Europe because a closed banking system will impact the Greek economy in short order. As tourism slows, public servants cannot be paid and as further debt maturities near, the Syriza government may see its leverage evaporate. Within the span of 10 days, the government will be compelled to issue IOUs as a parallel currency. At that point, Prime Minister Tsipras must either:

- Negotiate terms acceptable to Europe
- Resign, unable to broker a deal that follows up on his "no austerity" promises, leading to national elections – which Europe would favour, or
- Take Greece out of the eurozone.

I have argued for years that Europe was a financial crisis that would become an economic, social, political and ultimately a humanitarian crisis – in that order. Sadly, Greece seems to be marching in this direction. The tough stance taken by Europe could backfire, leading to A) a Greek voluntary default and exit from the Eurozone, or B) rioting and a military government taking charge to force new elections.

The ECB
The run on Greek bank deposits has left the country's banks entirely dependent on an ECB liquidity program (see Figure 2). This program is only permitted to be extended to banks in countries in a bailout program and not in default. Greece now technically fails these conditions. A change in collateral terms or suspension of the program would immediately bankrupt the Greek banking system. Our expectation is that the ECB will defer to Brussels in supporting Greece with program flexibility; however, a hard default by Greece on ECB loans due July 20 may be irreconcilable. In the event of default and currency redenomination, expect the Greek banks to all be nationalized and depositors to suffer haircuts and devaluation of savings. I hope clients were able to heed our warnings over the past several years to not keep deposits in Greek banks.

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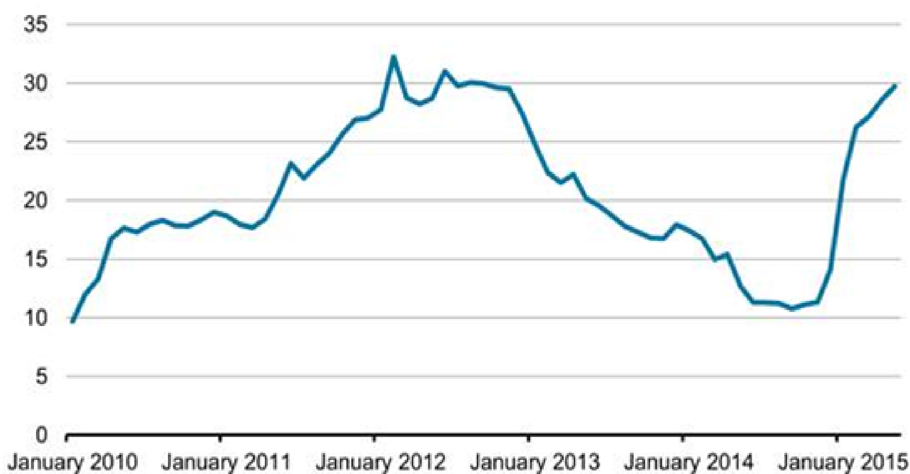
Figure 2



End game

In the case that Greece exits the EU, the divisive political consequences will be lasting. A permanent increase in the European risk premiums will emerge. This would put pressure on equity prices, drive the euro lower and credit/sovereign spreads higher. ECB Chairman Mario Draghi's promise to eliminate redenomination risk will be rendered impossible.

The low-growth world is not a backdrop conducive to shedding debt loads – unfortunately, this could lead to more Greece-like accidents in the future.

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