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CAPITAL INSIGHTS

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GREECE IS THE WORD

Unless you have been living on a desert island, you are aware that Greece is in the midst of trying to resolve its financial difficulties with European authorities. This is just the latest round in a financial drama that has been playing out for a number of years now. Up to this point, the solution by both Euro authorities and Greek leaders has been to “delay” any type of financial resolution. And that is the exact prescription handed down just a few weeks ago as Greece approached a February month end debt payment of magnitude it could not meet. Greece has been given another 4 months to come up with some type of debt agreement/restructuring plan. At this point we’ve simply stopped counting how many times Euro authorities have kicked the Greek can down the road as it has become routine.

Why all of the drama regarding Greece? Greece represents about 2% of Eurozone GDP. Who cares whether Greece is part of the Euro or not as the Greek economy simply isn’t a big enough piece of the entire Euro economy to really matter, is it? The fact is that the key problems in the Greek drama have very little to do with the Greek economy specifically. The issues illuminate the specific flaw in the Euro as a currency and the fact that the Euro authorities are very much hoping to protect the European banking system. The reason we need to pay attention is the ultimate resolution of these issues will have an impact on our investment decision making.

If we turn the clock back to 1998 when the Euro was initially formed, one key characteristic of the currency was that there was to be no one overall guarantor of Euro area Government debt. Think about the US. If the US borrows money to fund building bridges in five states, the US Government (via the taxpayer), is the guarantor of the debt taken on to fund the projects as it is not the individual debt of the five states involved. Yes, individual US States can take on State specific debt, but States cannot print money as can large Governments so there are clearly limiting factors. In Japan, the Japanese Government guarantees Yen based Japanese Government debt. In the US, the Government guarantees US Dollar based Government debt. In Europe, there is no one singular “European Government debt” guarantor of essentially Euro currency Government debt. The individual countries are their own individual guarantors.

The Eurozone represents the only common currency on planet Earth without a singular guarantor of Government debt. All the Euro area Governments essentially guarantee their own debt, yet exist in a common currency and interest rate structure. No other currency arrangement like this exists in today’s global economy. Many have called this THE key flaw in the design of the Euro at inception. Many believe the Euro as a currency cannot survive this arrangement. For now, the jury is out on the question of Euro viability, but that question is playing out in individual country specific drama, such as Greece is now facing.

One last key point in the Euro currency evolution. As the Euro was formed, the European Central Bank essentially began setting interest rate policy for all European countries. Their decisions, much like the Fed in the US, impacted interest rates across the Eurozone economies. Profligate borrowers such as Greece enjoyed low interest rates right alongside fiscally prudent countries like Germany. There is no interest rate differentiation for profligate or prudent individual Government borrowers in Europe. Moreover, the borrowing and spending of profligate countries such as Greece, Italy, Spain, Portugal, Ireland, and yes, even France, for years benefited the export economies of countries such as Germany. The more periphery Europe borrowed, the better the Germany economy performed. This set of circumstances almost seemed virtuous over the first decade of the Euro currency existence. It is now that the Government debt imbalance chickens have come home to roost, Greece being the opening act of a Euro peripheral Government balance sheet drama that is far from over. Even if we assume the Greek debt problem can be “fixed,” without a single guarantor of Euro Government debt going forward, the theoretical Euro currency flaw remains. Conceptually, there is only one country in Europe strong enough to back Euro area debt, and that’s Germany. Germany’s ongoing answer to potentially being a guarantor of the debt of Greece and other Euro area Governments? Nein. We do not expect that answer to change any time soon.

You’ll remember that over the last half year at least, we have been highlighting the importance of relative currency movements in investment outcomes in our commentaries. The problematic dynamics of the Euro as a currency has not been lost on our thinking or actions, nor will it be looking ahead.

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The current debt problems in Greece are also reflective of another major issue inside the Eurozone financial sector. The fact is that major Euro banks are meaningful holders of individual country specific government debt. Euro area banks have been accounting for their investments in Euro Government debt at cost basis on their books, as opposed to marking these assets to market value. In early February, NY based consulting firm Lazard suggested that Greece needs a 50% reduction in their debt load to be financially viable. Germany and the European Central Bank (ECB) want 100% repayment. You can clearly see the tension and just whom is being protected. IF Greece were to negotiate a 50% reduction in their debt, any investor (including banks) holding the debt would have to write off 50% of the value of their investment. At the outset of this commentary we asked, why is Greece so important when it is only 2% of Eurozone GDP? Is it really Greece the Euro authorities want to protect, or is it the Euro banking system?

Greece is a petri dish. IF Greece receives debt forgiveness, the risk to the Eurozone is that Italy, Spain, Portugal, etc. could be right behind them requesting equal treatment. The Eurozone banking system could afford to take the equity hit in a Greek Government debt write down. But it could not collectively handle Greece, Italy, Spain, and other debt write downs without meaningful financial ramifications.

The problem is real and meaningful. There exist nine countries on planet Earth where debt relative to GDP exceeds 300%. Seven of these are European (the other two are Japan and Singapore):

	Debt As % Of GDP
IRELAND	390%
PORTUGAL	358
BELGIUM	327
NETHERLANDS	325
GREECE	317
SPAIN	313
DENMARK	302
SWEDEN	290
FRANCE	280
ITALY	267

As we look at the broad macro landscape and the reality of the issues truly facing the Eurozone in its entirety, what does another four months of forestalling Greek debt payments solve? Absolutely nothing.

How is the Greek drama/tragedy important to our investment strategy and implementation? As we have been discussing for some time now, relative global currency movements are key in influencing investment outcomes. Investment assets priced in ascending currencies will be beneficiaries of global capital seeking both return and principal safety. The reverse is also true. While the Greek debt crisis has resurfaced over the last six months, so too has the Euro lost 15% of its value relative to the dollar. Dollar denominated assets were strong performers last year as a result.

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The second important issue to investment outcomes, as we have also discussed many a time, is the importance of capital flows, whether they be global or domestic. What has happened in Europe since the Greek debt crisis has resurfaced is instructive. The following combo chart shows us the leading 350 European stock index in the top clip of the chart and the German only stock market in the bottom.

Broadly, Euro area equities have not yet attained the highs seen in 2014. But quite differently, German stocks are close to 15% ahead of their 2014 highs. Why? Germany is seen as the most fiscally prudent and financially strong of the Euro members. What we are seeing is capital gravitating toward the perception of safety that is Germany, relative to the Euro area as a whole. This is the type of capital flow analysis that is so important in the current environment.

The headline media portray the Greek problem as just another country living beyond its means and unable to repay the debts it has accumulated. But the real issues involved are so much more meaningful. They cut to the core of Euro viability as a currency and stability in the broad Euro banking system. The Greek problem resurfacing in the last six months has necessarily pressured the Euro as a currency and triggered an internal move of equity capital from the broad Euro equity markets to the perception of strong individual countries, such as Germany. This is exactly the theme we have been discussing for months. Global capital is seeking refuge from currency debasement and principal safety in the financial markets of strong balance sheet countries. For now, the weight and movement of global capital remains an important element of our analytical framework.

Watching outcomes ahead for Greece within the context of the greater Eurozone will be important. Greece truly is a petri dish for what may be to come for greater periphery Europe. Outcomes will affect the Euro as a currency, the reality of the Greek economy, the perceptual integrity of the Euro banking system, and both domestic and global Euro driven capital flows. For now, Greece is the word.

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