Market Insight

Greece on the Brink

With negotiations between Greece and its troika of creditors — including the International Monetary Fund, European Central Bank and European Union — at an impasse, the country and the currency union to which it belongs are heading into unchartered waters. At this point, any number of outcomes seem possible, from a deal that secures additional bailout funds for the beleaguered nation to its so-called "Grexit" and return to the drachma.

After weeks of apparently fruitless negotiations — which you'll recall followed a four-month extension granted to the country in March when that round of talks broke down — Greece's current bailout package was set to expire on June 30, a date that coincided with a €1.55 billion payment due to the International Monetary Fund. With that deadline looming, representatives gathered in Brussels the weekend of June 27 and 28 for a last-ditch sit-down, only to be blindsided by Greek Prime Minister Tsipras' announcement of a July 5 referendum in which the Greek public will be asked to vote "yes" or "no" on the latest bailout proposal and its conditions. Tsipras at that time also requested of his creditors an extension of the country's existing bailout, an appeal not surprisingly denied.

Given the uncertain landscape, the European Central Bank on July 28 capped its emergency credit line for Greek banks at €89 billion. With meagre cash on hand and no access to international private markets, Greece was forced to shutter its banking system; Athens ordered lenders to keep their doors shut until after the referendum and limit ATM withdrawals to €60 per day (to the extent that depositors can find a stocked cash machine). And even when the banks do reopen, normalcy is likely some ways off if Cyprus' experience with bank capital controls in 2013 is any indication.

On June 30, just hours before its current bailout package was to expire and its payment was due to the IMF, Greece floated another bid for aid from the euro zone bailout fund as well as an extension of the existing rescue program; these entreaties were summarily dismissed by euro zone finance ministers. As a result, Greece was unable to make its scheduled payment to the IMF, technically putting it in what the IMF terms "arrears" and marking the first time in the 70-year history of the IMF that an advanced economy failed to meet its obligations.

The latest polls indicate that 46% of Greeks support a "no" vote on the bailout referendum versus 37% leaning toward "yes"; however, "no" support has weakened markedly since authorities introduced capital controls and closed banks, as Greeks perhaps got a taste of what a euro-less future may hold. Meanwhile, reports as of the morning of July 1 suggest Tsipras may be in a more conciliatory mood, lending hope that some sort of agreement with creditors may be possible.

We asked the leaders of our four investment platforms for their thoughts on this rapidly evolving situation.

Equity

We believe Greece and its creditors will ultimately arrive at some sort of agreement, with compromises being made on both sides of the table. That said, whatever the near-term outcome of this saga, Greece's impact on equity markets — both in Europe, the U.S. and elsewhere — will be more psychological than material. We do not believe contagion through the euro zone will be an issue; the country is significantly "ring-fenced" from the rest of the currency bloc, and Greece's troubles should have only minor impact on its neighbors.

While the flight to quality may continue for some time, equity markets ultimately will look at Greece as an isolated and manageable event and will refocus on investment fundamentals. We would consider any exaggerated selloff in European stocks to be a buying opportunity.

Fixed Income

When markets opened on Monday after the tumultuous weekend, risk-off was the theme: Greek bond prices plummeted, the euro weakened, spreads on European banks widened and yields on safe-haven German bunds pushed lower. U.S. markets reacted in sympathy upon their opening hours later, with spreads widening and yields on Treasuries falling. However, conditions both here and abroad stabilized as the day wore on and into Tuesday, as traders grew more comfortable that the appropriate controls were in place to mitigate contagion should Greece default on its obligations or ultimately be forced to abandon the euro.

With bailout proposals continuing to circulate, it's hard to get a read on the final content of the July 5 referendum much less its outcome. Regardless, further market disruptions and volatility could provide opportunities for investors, including buying U.S.-based spread assets on

weakness and/or reducing U.S. interest rate exposure should the flight to quality appear overdone.

Multi-Asset Strategies and Solutions

Though we are not planning to make changes to our portfolios at this time, we are keeping a close eye on the July 5 referendum. The market is pricing in a 50% chance of a Grexit; a "no" vote by the Greek people on July 5 would increase these odds. However, even if Greece defaults and/or exits the currency bloc, we believe the impact will be contained for two reasons: 1) the small size of the Greek economy relative to the world economy and 2) the willingness of the ECB to ease policy should conditions become deflationary. In addition, we believe the ECB has and will continue to take the necessary steps to ring-fence Greece from the rest of Europe. There is always the chance that a Greek default and/or exit from the currency union triggers some type of global contagion event, though that is far from our most likely outcome.

The biggest risk remains for the Greek economy and people, as a Grexit would lead to higher inflation and lower economic output and would be devastating to the country's pensioners. Once the dust settles, fundamentals will once again determine the direction of the markets, and we would consider shifting some equity exposure from the U.S. to Europe in the event of significant European underperformance.

Senior Loans

The loan market, while minimally exposed directly to Greek issuers (only 0.43% of the S&P/LSTA Leveraged Loan Index as a percent of par as of May 31), has witnessed some increased volatility this week as risk-off trading increased across capital markets, though volatility in loans was relatively lower than that of other asset classes. Traders do not report any rushed selling in the market, and the bid decrease is primarily a reflection of the risk-off sentiment. Increased selling in the high yield space tends to leak into the loan market, particularly impacting the more liquid loan names, and we may see some increased volatility of European issues in the near term. Growing uncertainty about Greece's fate has caused issuers to rush to close deals in the new-issue market this week, though this may also be partially a function of the abbreviated market week here in the U.S.

Overall, it's likely that the loan market will ride out this Greek episode with lower overall volatility than other asset classes (though it will not be wholly unscathed), particularly given that a large percentage of Greek debt is held by European institutions and not to any large degree by global banks. This, we believe, should contain any potential global systemic banking impact and any further trickle down into the loan market.

A Quick Look at Puerto Rico

Another debt crisis is gathering attention closer to home, as the governor of Puerto Rico recently declared the island's $72 billion in debt — a greater sum per capita than any U.S. state — "not payable" as the commonwealth looks to repair its struggling economy. Some have warned that Puerto Rico may run out of cash within a month, potentially resulting in a government shutdown and other emergency provisions. Standard & Poor's recently lowered its rating on Puerto Rico's general obligation debt to CCC- from CCC+, with a negative rating, noting that a default, distressed exchange or redemption of the commonwealth's debt looks likely within the next six months. The price of some Puerto Rican GO bonds sold last year are now trading at only 68 cents to the dollar. Municipal bond funds and ETFs are major investors in Puerto Rican debt thanks to its triple-tax exempt status, as are hedge funds.

The White House has said that Puerto Rico would not be given a federal bailout, though it has suggested that Congress consider legislation allowing the island's public corporations access to the same bankruptcy protections enjoyed by those in the 50 states. Further complicating the issue, Puerto Rico also lacks access to Chapter 9 of the bankruptcy code that enables municipalities to restructure their debts; in 2013, Detroit became the largest municipality to file for Chapter 9 bankruptcy protection.

In a bit of good news, the Puerto Rico Electric Power Authority reached a deal with creditors that would allow it to pay more than $400 million to bondholders, averting what many feared would be the first of many defaults among Puerto Rican entities. Though given the challenges that bedevil the commonwealth, it just may be a case of delaying the inevitable.

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