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GLOBAL INSIGHT

SPECIAL REPORT

Getting Past Greece

Uncertainties raised by Greece will eventually be trumped by the strengthening performance of most developed economies led by the U.S.

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Special
Report

Getting Past Greece

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The Greek debt negotiation blew up this past weekend and pushed equity markets into a correction that may take some time to fully play out. We expect this pullback will eventually give way to a resumption of the long-term uptrend that we think has longer to run on the back of strengthening economies in North America and in most of Europe.

In the near term, we recommend reviewing portfolios and bringing equity exposure back to strategic target weights. Some cash on hand could prove valuable in the event that markets over-correct.

Greece has been front and centre in the financial news for a couple of months. As of writing, the situation has not been resolved. Nor will the results of this Sunday's referendum necessarily make things any clearer. Nor too is any solution likely to be clean and final. It is conceivable that we could be reading and writing about the Greek situation for several more years to come.

Contradictory Politics

The Greek political situation is inherently contradictory: in the January election voters gave the ruling party a mandate (if 36% of the vote can be called that) to stand up to creditors' demands for structural economic reforms even as public opinion polls have consistently shown a strong preference (70%+) for staying within the euro.

Markets largely ignored Greece until negotiations collapsed.

This is reflective of a fractious political mindset throughout much of Europe. The U.K.'s commitment to holding an "in/out" referendum on its EU membership by 2017, a challenging upcoming Spanish general election, and the growing polling strength of "euro-skeptic" parties across the region suggest that voters throughout Europe are restive.

Up until this week, one would have been hard pressed to see this by looking at financial markets.

Since the middle of April, even as Greece dominated the headlines, the euro strengthened by 9% versus the U.S. dollar. The Eurostoxx index, after gaining 37% from October to April, had given back less than one-fifth of that advance.

European economic performance explained much of this market equanimity. Q1 GDP growth for almost every country in the EU exceeded market forecasts. Economists' estimates for the rest of the year were duly raised and may be boosted further. Importantly, European banks appear to be back in the business of lending money. Loans to the private sector have grown for five consecutive months after falling nonstop for three years.

Further, the Greek drama had no noticeable impact on North American markets. Pundits fretted endlessly about Fed intentions, but through this the S&P 500 managed to flirt with new highs. Meanwhile, the S&P/TSX was only about 5% off its September 2014 all-time high, despite the carnage visited on the heavyweight (approximately 30% of the index) energy, gold, and commodity sectors over that period. Treasury and Government of Canada bond yields were moving higher, not falling as one would expect if there was growing risk aversion in the market.

Weekend Seismic Shift

That may have changed with the events of this past weekend. Our position is that markets are now correcting to reflect the much higher probability of a Greek exit from the euro or at least the unexpected interjection of a referendum. The latter carries with it a much longer interval before any deal with its eurozone partners could be concluded.

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Short of an out-of-left-field agreement, which we don't expect to materialize, this period of uncertainty is likely to last several weeks, possibly months.

In order to become something worse than a correction, in our view, global credit conditions would have to deteriorate sufficiently to usher in a renewed global economic downturn. In particular, the U.S., Canada, the U.K., Germany, and the other core developed economies of the eurozone would have to be heading toward recession brought on by a sudden tightening of credit conditions.

We believe this is unlikely. Central banks are accommodative and commercial banks are in much better shape than they have been in many years. Eurozone banks raised large amounts of new capital last year. And in December, the results of the European Central Bank's stress test revealed that all but a handful were in a position to withstand much greater turmoil than any Greek outcome is likely to deliver.

Unlike Lehman Brothers, whose debt obligations were spread throughout the financial system, about 80% of Greek debt is concentrated in the hands of eurozone central banks and the International Monetary Fund. Of the 20% in the hands of the private sector, a substantial piece is held by Greek banks, almost nothing by foreign banks.

So by our reckoning the systemic risks outside of Greece are not large.

And elsewhere, after a weather/port strike-induced Q1 blip, the important U.S. economy appears to be strengthening. Employment, wages, housing construction, autos, as well as consumer and business confidence are all on the upswing. This holds positive ramifications for its many trading partners and for global attitudes.

Risk Management Always Appropriate

Good portfolio management practice argues for building in a margin for error. In the period we have been living through, during which share prices have been mostly rising since the financial crisis lows of 2009, this has become progressively harder to do as risks have been consistently to the upside.

And our base case continues to be that notwithstanding corrections such as the one we think may be unfolding, share prices should move higher on balance over the next couple of years.

That said, we see at least two actions as always appropriate: rebalancing portfolios to bring overall equity exposure back toward long-term strategic targets and culling individual stocks that are no longer delivering the business results expected of them. We would use the coming days to ensure that portfolios are correctly balanced between acknowledging near-term risks and pursuing longer-term opportunity.

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