Market Bulletin

19 June 2015

This time it really is crunch time for Greece

The Greek situation looks bleaker than it did a week ago and much worse than at the start of the month. A meeting of eurozone finance ministers yesterday ended in failure with Eurogroup Chair Dijsselbloem saying Greece was "moving in the direction" of euro exit and openly questioning whether Greek banks would open their doors on Monday. More than EUR 2 billion is reported to have been taken out of the banking system in recent days, and the European Central Bank (ECB) Governing Council is deciding today whether to change the support it offers Greek banks via its Emergency Liquidity Assistance (ELA), having raised the cap on that support only two days ago. Depending on the outcome of that meeting, capital controls—or a bank holiday—in Greece are a mounting possibility.

There's an emergency summit of eurozone leaders on 22 of June, with finance ministers' talks over the weekend. It's possible that policy makers will come up with a last-minute proposal in the next few days to break the impasse. But there's little sign of that kind of "hallelujah" moment right now. As a result, we believe there is now a roughly 75% probability of some kind of Greek default—up from 50% a month ago. However, we would still not put the chance of Greek exit from the euro higher than 30%.

To be clear, we believe things could get very messy for Greece in the event of a default, but only a few of these dark scenarios would end in Greece leaving the single currency area. Most Greeks still want to stay in, even if it means accepting the austerity and structural reforms that Syriza was elected to prevent. For that reason, we think a change of government in Greece is now more likely, than a change of currency. But investors should realise that either—or both—of these scenarios is eminently possible.

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There have been sporadic signs of Greek contagion in European markets, but, in general investors' reaction to this deteriorating situation has been extraordinarily muted. This makes sense in a week when the US central bank has rightly been at the centre of many investors' concerns. Europe's banks are much less exposed to Greek debt than they were in 2012. A supportive final ruling of the European Court of Justice has also confirmed that the ECB is legally entitled to use weapons such as Outright Monetary Transactions—bond purchases—to protect other eurozone countries from Greek fallout. However, these and other "firewalls" have not yet been tested and require a degree of decisiveness that we have not always seen from eurozone officials. If Greece does descend into even deeper political and economic chaos, it's difficult to believe that European financial markets will remain unmoved.

The market reaction so far

Globally, the most important force moving markets this week was the US Federal Reserve meeting and Janet Yellen's press conference, but those closer to Athens have felt the effects of the crisis:

- Volatility in European assets has jumped, with the VDAX reaching its highest point since the summer of 2012, but US investors seem to feel insulated from the situation and volatility in US equities and fixed income has not really been affected.
- Short-dated Greek debt has come under particular pressure. Yields on Greek two-year debt are now close to 30% and Greek three-year debt sitting at 22%.
- The Athens stock exchange is down 17% in just five trading days and the Athens stock market is down 17% year to date.
- The Stoxx 600 is down nearly 2% over the same period, led by financials (down 2.9%). Europe's main index has lost 7% since its highs in mid-April, but is still up 13% year to date.

EXHIBIT 1: CHANGE IN EUROPEAN BOND YIELDS
YTD and QTD

	Yield	YTD bps	QTD bps
Greece	12.64	322	117
Italy	2.27	42	103
Spain	2.24	63	103
Portugal	3.08	53	140
Ireland	1.66	48	102
Germany	0.81	37	66

Source: FactSet, J.P. Morgan Asset Management. Data as of 19 June 2015.

The table above, and the charts, graphs and tables presented herein, are for illustrative purposes only.

Recent moves in European bond yields are summarised in **Exhibit 1.** Most of the rise in yields since late April has nothing to do with Greece.[1] But periphery bond yields have moved with Greek ones at various points in the past few weeks. There have also been signs of safe-haven flows into bunds, Swiss francs and gold, which saw a one-day rise of 2% on 18 June.

EXHIBIT 2: KEY UPCOMING DATES FOR GREECE

Date	Event	Payment due
18-Jun	General council meeting of the ECB in Frankfurt	
18-Jun	Eurogroup meeting	
19-Jun	ECB call on Greek banks access to ELA	
19-Jun	Greek T-Bill (GTB) redemption	€1.60bn
19-Jun	European Union finance ministers meeting	
22-Jun	Eurogroup leaders summit	
25-Jun to 26-Jun	European Union leaders summit in Brussels	
30-Jun	**IMF payment**	**€1.54bn**
30-Jun	**Salaries and pensions**	**€2.50bn**
30-Jun	**Bailout expires**	
10-Jul	Greek T-Bill (GTB) redemption	€2.00bn
13-Jul	IMF loan repayment due	€0.46bn
14-Jul	International bond redemption (JPY)	€0.09bn
16-Jul to 20-Jul	Greece needs to service interest payments on government bonds	€0.63bn
17-Jul	Greek T-Bill (GTB) redemption	€1.00bn
20-Jul	Greek government bond redemption and interest payment due	€3.62bn
25-Jul	International bond redemption	€0.02bn

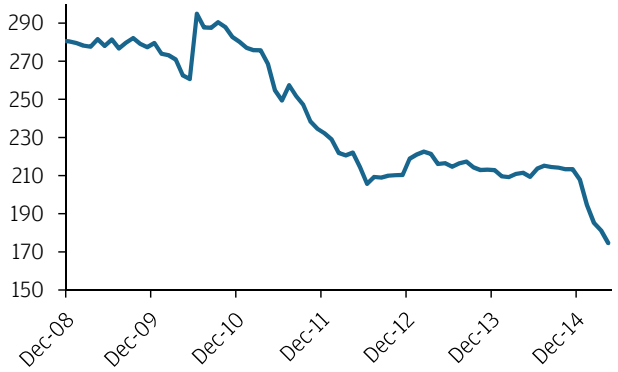
Source: Bloomberg, European Commission, ING, International Monetary Fund (IMF), J.P. Morgan Asset Management. IMF loans in SDR converted to euro as of 18 June 2015. Data as of 18 June 2015.

[1] As discussed in a recent market bulletin, "Market Insights—European assets: Volatility strikes back", Stephanie Flanders and Alex Dryden, J.P. Morgan Asset Management, 12 June 2015

The road ahead

As expected, there was no breakthrough in this week's European finance ministers' meeting, which ended with the European Commission President calling a summit of eurozone leaders on Monday 22 June. This will probably involve a meeting of eurozone finance ministers over the weekend, but in the absence of a new compromise proposal from Greece, they may not have much to discuss. Another potential—but not very suitable—forum for a deal would be the European Union leaders' Summit on 25 and 26 June. But by then, many believe it will be too late for Greece to get the parliamentary approval it needs in time for funding to be released before the 30 June repayment to the International Monetary Fund (IMF). We discuss the implications of a failure to make that payment in this article.

EXHIBIT 3: DEPOSITS & REPOS OF MONETARY FINANCIAL INSTITUTIONS IN GREECE (EXCLUDING THE BANK OF GREECE)
€ BILLIONS



Source: Bank of Greece, J.P. Morgan Asset Management. Data as of 18 June 2015.

In the meantime, all this uncertainty has led to accelerating flows of deposits out of the Greek banking system (**Exhibit 3**). Deposits in Greek banks fell 17% in the first four months of 2015, after Syriza was elected. Since then, the outflows are said to have escalated, with Reuters reporting outflows of EUR 400 million on 15 June alone and EUR 2 billion over the course of this week. Total deposits are the lowest in a decade, and at least 40% lower than in 2010.

This has raised the prospect of Greece using capital controls or bank holidays to ration the country's remaining liquidity and contain the damage to domestic banks.

- Bank holidays are the most extreme option, since they involve a total freeze on banking. As a result, they are also inherently temporary, rarely lasting more than a few days.
- By contrast, capital controls put limits on transactions, while still allowing the banking system to operate.

We have seen these kinds of controls work reasonably smoothly in Cyprus, which enforced capital controls in 2013 while negotiating a bank rescue programme with European creditors. But in the Cypriot case, the negotiations centred only on a rescue package for the banking system and the capital controls were only imposed with the approval of other EU members.

The situation in Greece is very different from Cyprus, and the impact on domestic and foreign investors would depend on the exact details. But one clear lesson of experience is that once imposed—even for temporary emergencies—such controls tend to be difficult to remove. They remained in place for two years in Cyprus and they are only now starting to be lifted in Iceland, nearly seven years after they were imposed. If controls are introduced in Greece without any deal in prospect, the effect on the domestic economy and broader market confidence could be rapid and quite severe. The first thing that any visitor notices about Greece is its extremely high reliance on cash.

What happens if Greece defaults?

Against this backdrop, some form of Greek default looks increasingly likely, and would largely involve default on official institutions and other governments (see **Exhibit 4**). But as we outlined in our previous Market Bulletin on Greece[2], there is no straight line between default and "Grexit".

The IMF's Managing Director, Christine Lagarde, has said that Greece will notify the IMF board immediately of any failure to make the 30 June payment. The country would then be considered a default on all of its other IMF loans. That would probably trigger a cross-default on Greek credit default swaps and the other sovereign debt that remains from the 2012 rescheduling deal, although some ratings agencies have questioned whether they would consider the missed IMF payment a full sovereign default.

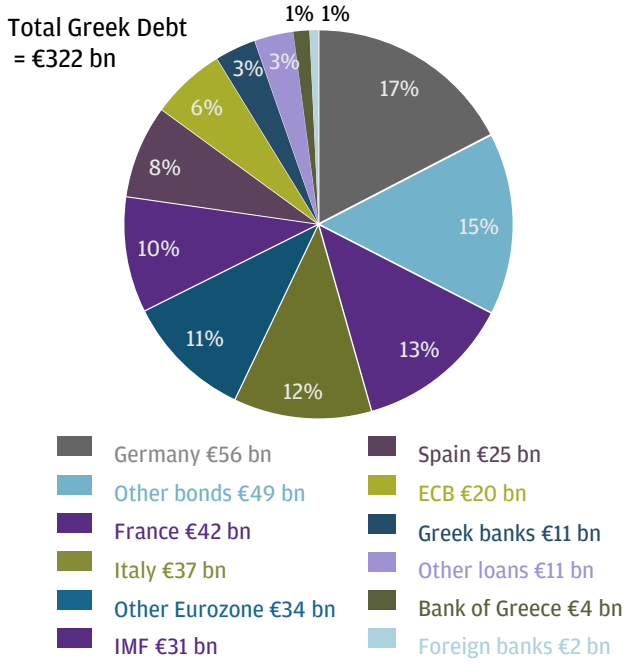
Whatever happens, the most important issue for Greece will be response of the ECB. This week, the ECB maintained Greek banks' access to its ELA—despite the lack of progress in negotiations with creditors—it even raised the ELA limit by EUR 1.1 billion, to EUR 84.1 billion. But ECB officials have also warned that the central bank can only support solvent banks. The question they are less willing to answer is whether the Greek banking system would be deemed solvent if the sovereign defaulted on all—or some—of its debt.

Council members have said they would move to restrict financing for Greek banks pretty quickly if Greece missed the 30 June payment. But if there is any sign of a deal with creditors, it is more likely to restrict Greek banks' access to the ELA—and increase the haircut applied to Greek bonds when they are used as collateral—than cut Greek banks off entirely.

ECB officials have said all along that the bank is a "rule-based" institution, and beyond that, the key decisions about Greece need to be taken by politicians. But that is going to be a difficult line to sustain in an environment in which the interpretation of those rules is deeply political. But the reality is that the solvency of the Greek banking system is utterly dependent on the stance of the ECB. The banks are solvent as long as Greece remains in the euro, and over any reasonable time period that requires continuous support from the eurozone's central bank.

The bottom line is that Greece can potentially default on certain obligations and still be part of the eurozone.. But we do believe the squeeze on the economy and the banking system that would follow from a default would greatly increase the chance of a "regime change" in Greece. The issue would be whether it is the government that changes—or the currency.

EXHIBIT 4: HOLDERS OF GREEK DEBT



Source: EFSF, Greek Public Debt Management Office, Open Europe, J.P . Morgan Asset Management. Data as of 17 June 2015.

[2] "Market Insights—Clock still ticking on Greek default", Stephanie Flanders and Nandini Ramakrishnan, J.P. Morgan Asset Management, 27 April 2015.

In fact, we think there is a good chance that default could strengthen domestic political support for staying in the eurozone, if it gives Greek voters a taste of what a messy exit from the single currency bloc would feel like. This week for the first time we saw a pro-euro rally on the streets of Athens. A recent survey by Proto Thema asked if Greece should choose between the creditors proposal or a "Grexit"—50% of respondents said the country should accept the creditors' proposal, with only 27% opting for a Greek exit as being the best option for the country.

Investment implications

The European financial system is now less exposed to Greek contagion via its banks and—theoretically—better equipped to deal with it. Any remaining question marks over the ECB's ability to intervene in bond markets to support eurozone governments were removed this week by a very broad and supportive ruling by the European Court of Justice on the legality of the ECB's Outright Monetary Transactions facility. Using that programme, or a variant of it, the ECB now has broad discretion to keep bond yields in periphery economies from spiralling out of control in the event of Grexit. The system also now has more flexible tools for supporting eurozone country banks, should any of these come under threat. But all of that requires coordination and decisiveness which eurozone officials have not always demonstrated in past bouts of volatility.

The key takeaway for investors is that the Greek crisis does not pose an existential threat to either the euro system or to Europe's financial system. Ultimately we do not believe that Greece alone will be enough to put the European recovery into reverse, or that it will prevent a gradual improvement in European corporate earnings. But there is still plenty of scope for nasty surprises and renewed volatility if the Greek situation continues to deteriorate.

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