Spotlight

Special Edition

The Greek "NO" and its consequences

- **Greeks vote "NO" by a comfortable margin in referendum**
- **Outcome will be interpreted differently by Greek government and the creditors, but increases risk of Grexit**
- **Both political and policy (ECB) response over coming days crucial for outlook for Greece, the Eurozone and financial markets**

The “Greferendum”

After months of increasingly tense negotiations between Greece and its creditors, and a failure to make debt repayment to the IMF, the Greek government organized a referendum yesterday in which voters were asked whether or not to accept an offer from its creditors consisting of further austerity and reform in exchange further additional financial aid. The process towards the set-up of the “Greferendum” was so tumultuous, confusing and poorly managed that the consequences of the outcome could only have been somewhat uncertain. The late and surprising timing, the lack of coordination by the Greek government with its creditors and the confusingly articulated referendum question on a poorly translated offer from the creditors – an offer that formally is no longer on the table after the expiration of Greece's second bail-out package on June 30th -- are an incomplete list of factors that make it hard to interpret the Greferendum outcome.

Moreover, the event has only helped further deteriorate the already very sour relationship between the Greek government and political leadership of the other member states of the Eurozone. The walkout by Greece from nearly finished negotiations with the creditors when the Greferendum was announced created a very bitter tone of voice amongst other Eurozone politicians. Suggestions by the Greek government that a deal would be close at hand, regardless of the outcome of the referendum, were publically disregarded as "completely incorrect" by Eurogroup President Dijsselbloem and European Commission President Juncker even spoke of "betrayal" of his Greek counterparts recently. Therefore, both the ability and the willingness to work constructively with the Greferendum result are lacking to a troubling extent.

As she has done more often, German Prime Minister Merkel articulated it most clearly last week by stating that a credible commitment to jointly adhere to the common rules that bind the Eurozone together is more important to the future of Europe than the financial details of a new deal with Greece. The trust that Greece is willing to deliver that commitment has sunk to an all-time low and, thereby, has reduced flexibility by the rest of the Eurozone members to help out it most vulnerable family member (again). This lack of trust will continue to create lingering uncertainty around whatever path forward will now be chosen by Greece and its creditors.

That is not to say that it was unclear what was at stake. The Greek government might have framed it differently than the Greek opposition and the Greek creditors, but it seems clear to everybody in Greece and outside of it that the Greferendum was basically a vote of confidence on the Greek's government ability to keep Greece within the Eurozone. The "No"-campaign of the Greek government was based on the premise that a better deal (less austerity and debt restructuring) could be reached with the creditors once the democratic backing was provided through the referendum result. The creditors’ position was always that Greece's "democratic" rights are not senior to those of voters in other Eurozone member states and therefore that a rejection of the bail-out conditions basically was a rejection to play by the Eurozone rules. The latter seems likely to be interpreted by the creditors as a desire to play its own rules and could therefore open a road towards Grexit.

The result: a convincing "NO" vote!

The Greek population voted "NO" by a comfortable margin (61%-39%) and handed the Syriza government another political victory. This will probably energize Prime Minister Tsipras and his team, but will also create huge uncertainty over the future of Greece in the Eurozone and lead to intensifying immediate economic hardship in Greece. At this time it remains unclear if and when banks will be able to re-open. Also, it might well be that deposit and savings haircuts (of those people the Syriza government claims to protect) will be on the table to prevent complete banking sector meltdown.

Already, the Greek trade sector is struggling to find funding for even the most essential imports, while exporters are finding it increasingly hard to get payment in euros as their customers do not want to hold euro balances within the Greek banking system. This type of issues seem likely only to intensify over the coming days.

Without a deal in the near-term between Greece and its creditors, a renewed and sharp recession in Greece seem likely. Both length and depth of such a contraction are still very uncertain and will depend on the evolution of domestic politics within Greece, the ability to get some kind of a deal that will allow for Greece to stay within the Eurozone or the social and political stability in the aftermath of Grexit.

To prevent the latter there will probably be renewed political pressure from Greece and possibly the European Commission and France to move towards an agreement. At the same time, sharp resistance against further support for Greece from several Northern European parliaments is equally likely. At this point it is very hard to predict how these forces will balance out, but given the firm comments from Merkel and Dijsselbloem on their interpretation of the referendum result it seems highly unlikely a deal can be found any time soon (if at all!).

A small positive in this respect was this morning's announcement that the Greek Finance Minister Varoufakis will step down. He has been a very confrontational figure and his resignation might be the Greek government's first effort to smooth its relationship with the creditors a bit. However, there is probably still a long way to go before trust and pragmatism are back at negotiation table.

At some point broad European leadership might come to the realization that it certainly shares responsibility for the creation of the current political problems, basically by allowing the economic circumstances to arrive in Greece that brought Syriza to power, but that seems unlikely to occur in the short run.

The economic impact on the rest of the region will run through financial markets and the feedback loops from markets to the real economy. Very different from earlier stages on the Euro crisis, direct financial links in the private sector are too small to have a material impact on European financial sector balance sheets. The trade links have never been large enough to pose a material threat to economic growth in the Eurozone. Still, some market contagion into peripheral bond and equity markets seems likely and probably also into European equities.

For the degree and sustainability of contagion it will be key how the ECB reacts to all the recent developments. Some of the recent action of the ECB, its quick statement on Sunday June 28th that it stands ready to safeguard stability in the Eurozone and the extension of eligible assets for its QE program into corporate bonds, hint at a pro-active stance during the coming days of uncertainty. Still, exact timing of ECB action remains difficult to assess and might only follow after a period of substantial market turmoil.

Three elements now key to watch

Three elements will be key to watch in the ECB's policy response to this political crisis. The way the Emergency Liquidity Assistance (ELA) is managed (to what extent will it remain open for Greek banks), the application of haircuts to the collateral that Greek banks need to post at the ECB and new measures to tackle liquidity issues in other parts of European financial markets. The balance between these three potential ECB measures will be crucial for the sentiment in financial markets and, thereby, the degree of damage to the European economy.

In the end, however, we have a high conviction that the ECB is willing and able to limit lasting damage from short-term contagion into other European markets. Especially since it is now operating against backdrop of a more unified political front in all of the other member states of the Eurozone that will allow for effective political support for creative policy action, if needed.

This basically means that significant declines in some market segments (peripheral equities/bonds, European equities, the euro) over the next couple of days cannot be excluded, but also that Eurozone break-up risk remains very small. The latter is a completely different situation than 2-3 years ago and therefore leads to different investment conclusions. As long as the global cycle remains on track, the upcoming period of market volatility might provide an entry point for investors once visibility on the future direction for Greece increases and the accompanying policy response is clear.

We remain cautiously positioned

In the short-term, it keeps us cautiously positioned and more focused on reducing rather that adding risk. However, we'll keep our asset allocation stance "close to the middle" and would only move more defensive once we see significant contagion in combination with disappointing policy response. For now, the latter is not our base case. As soon as more visibility on politics, policy and the impact on the global cycle is there, it could well be that we move back towards a more risk-on stance later in the summer. Obviously the situation remains very uncertain and we will be monitoring very closely if additional changes in our allocation stance are needed once the facts change in an unexpected way.