Sanlam Investments

SIM Global
Market review

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Greece: A storm in a European tea cup?

Background

Greek PM Alexis Tsipras and his finance minister have been accusing Germany of blackmailing Greece and criminally robbing Greeks of their dignity. This does have an element of truth as it was under pressure from Germany and France that the 2011 referendum (called by then Greek PM George Papandreou to legitimize the debt bailout) was cancelled.

But since then European taxpayers have been funding Greece's deficit, via what effectively was a bridging loan. This was supposed to give Greece time to structure a repayment plan based on austerity measures and sale of assets. Is it right for the Greeks to now complain that it was forced on them? The reality is that debtors never have a lot of negotiation power - it sounds harsh, but that's what happens when you build up excessive debt, whether you are an individual, corporate or government.

Where are we now?

Greek Prime Minister Tsipras' call for a referendum on Saturday morning (at the proverbial 5 minutes to 12) was a few months too late and made at the point that the Greek government had nothing left in the kitty to pay creditors or its civil servants, plus their banks had insufficient liquidity to make payments or be in a position to pay out uncapped withdrawals. Whilst Tsipras and his finance minister Varoufakis* were "gaming" European leaders, Greek citizens stood in queues at ATM's withdrawing deposits from the banking system.

**Varoufakis is a professor in game theory, and from the beginning has been trying to "outgame" his European counterparts using various strategies. Sadly for him and his country Angela Merkel didn't blink. Looking back, his biggest mistake was to ignore the German problem, i.e. it couldn't allow Greece to restructure its debt.*

So the situation to be resolved via a referendum is: Greek debt owing to European governments is ±€300bn representing 3.4% of Europe's gross domestic product (GDP). Europe refuses to lend more unless the Greeks commit to reforms, as effectively each taxpayer in Europe has already lent 3.4% of his/her earnings to Greece, whilst at the same time pushing out their own retirement age.

A "No" vote means that Greeks refuse to change their lifestyles (i.e. work longer and/or pay more tax) to repay their country's debts. It also means that the European dream (Better, Together) is at risk and that the experiment of having one currency for countries with different productivity levels will be questioned again. It almost certainly means Greece reverting to the drachma and the government nationalising the illiquid, but then most probably also insolvent banks, further adding to its debt burden. Europe has to write-down the funds lent to Greece, money that could have been used for other purposes.

A "Yes" (rejecting Tsipras' call to refuse austerity and help) would most likely mean an election for a new government who will hopefully be mandated to negotiate a new austerity program.

The Greek electorate is facing a tough choice: "Yes" = hardship, "No" = chaos and being cut adrift on their own with soaring inflation for a few years.

What now? Banks closed, no money left. IOU's the way to go?

By the time you read this the Greek government will have defaulted on its loan repayments due this week, which means it has lost access to ECB help. Unlike independent governments, it doesn't have the ability to print money to fill the shortfall and has no friendly bankers to turn to (worryingly for the West though is that the Russians and Chinese are interested to provide funds and so gain influence).

In the meantime (a few months?) the government cannot pay its civil servants or any other obligations (who will pay the printers, organisers, etc. of the referendum and election?).

A possible way out of this is if the Greek government prints IOU's which its citizens can use to buy goods and services, but these IOU's will most probably immediately "trade" at a discount against Euros as a means of payment.

But at least the referendum gives Greeks a final chance to vote whether to stay in the Eurozone (and for austerity measures) and against a Tsipras-led exodus out of the currency union.
This will all take time and it is not impossible that the situation could trigger violent public protests which could morph into a revolution. Both Syriza (extreme left ruling party) and Golden Dawn (extreme right) have a tendency to resort to violence and the next few weeks could well see Greece descend into anarchy, during hot-headed referendum and election campaigns.

Europe: Despite the tumult, the Greek problem remains a storm in a European tea cup

During the 2010 European sovereign debt crisis Greece was pivotal and seen as the domino that could trigger a chain reaction. Five years later Greece is the weakest link. Removing it from the Eurozone could strengthen Europe.

Why all the fuss then? The Greek economy equates to less than 2% of Europe's GDP. Europe's entire banking system has only about €34bn exposure to Greece (down from almost €300bn in 2009). It is also unlikely that any large European exporters or banks have uncovered debt exposures to Greece.

True, default would hurt (even for a combined Europe €300bn is real cash), but similar to the recent African Bank default in South Africa where investors found that the net asset values of their funds had been reduced, it was soon forgotten.

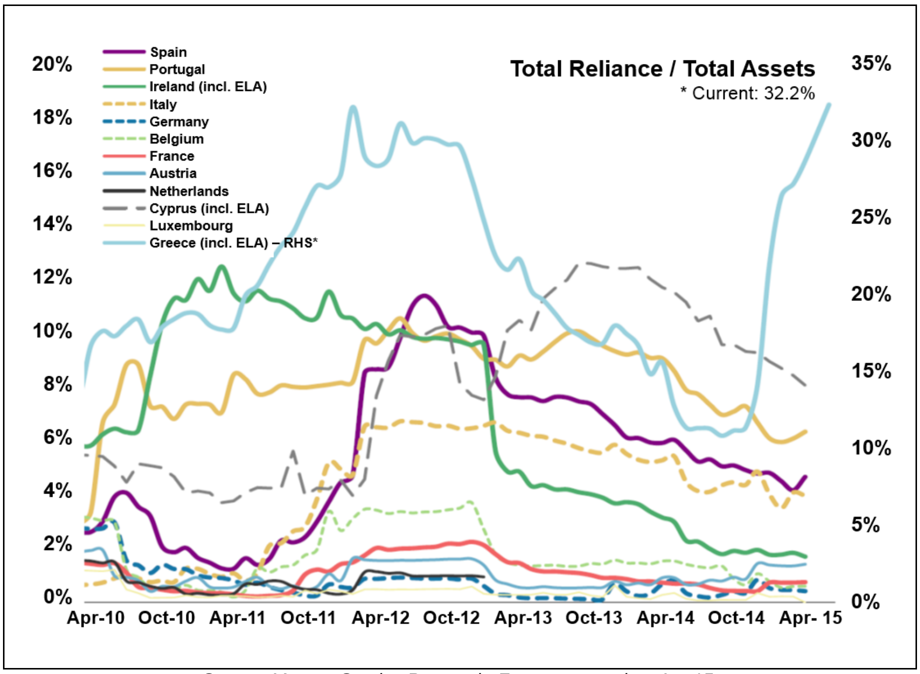
In the short-term Mario Draghi (ECB President) would do "whatever it takes" to maintain stability. But longer term the concern would be that letting Greece go opens the door for future disgruntled members to leave as well, weakening the whole idea of a European union.

Greece leaving the EU means they could abandon austerity and start printing money – probably drachmas. This would increase the cost of their euro denominated debt but make Greek exports cheaper. Imports to Greece would become expensive putting upward pressure on inflation whilst foreign investments would only be available at a high price with many strings attached.

There is no short-term happy ending to this story for Greece.

However, in terms of Europe, markets have over-reacted. **Our opinion is that this doesn't reflect the importance of Greece but rather the fact that market valuations are rich and expectations have been unrealistic**.

Graph 1: Greek Banks' dependence on Eurosystem



Source: Morgan Stanley Research, France sector data Apr 15.
** for Greece its latest available data as at 22 June 15*

So how should investors handle this?

Never make investment decisions based on the outcome of unpredictable situations such as these. Invest where the "odds" are in your favour: Whether good or tough times, investing in well-managed companies with good track records. Time has shown that well managed companies come through storms stronger. Why? Because they are better capitalised and have management teams that are on the front foot that can use opportunities presented by a crisis.

A perfect example of this was the difference between Citigroup and Wells Fargo during the 2008 crisis:

Table 1: Shareholder Wealth

	2004	2014	Compound Return
NAV per Share			
Citi	120	57	-7%
Wells Fargo	8	27	13%
Share Price			
Citi	491	54	-20%
Wells Fargo	31	55	6%
Share price plus divis rebased to a $100			
Citi	1008	106	1%
Wells Fargo	100	356	14%

Source: SIM Global

Needless to say: None of the SIM Global funds have any exposure to Greece or companies that are directly dependent on a positive outcome of the Greek situation.

Is it possible to pre-select winners, and if so, why do so few investors do it?

Selecting winners is not easy and the hardest part is patience. Most investors fall into the trap of wanting to book quick gains. For example, the share price of Barclays fell to 50p towards the end of 2008 (currently 264p). But choosing the right day and share during a crisis is only possible with hindsight or luck. I know of many investors who chose to invest in Lehman's, Bear Sterns, Royal Bank of Scotland, Lloyds, African Bank, etc. (the list is long). Investing at the end of the previous financial crisis (Dec 2008) in e.g. Berkshire Hathaway or Wells Fargo, has been considerably better than investing in "cheap" Citigroup or Barclays.

The message in a crisis is that unless the companies you're invested in have become very overpriced relative to their underlying value, you should rather use a market correction to add to your current investments. After all, those are the ones you did your homework on and hence understand well, not so?

Remember Aesop's wisdom so regularly quoted by Warren Buffett: **"A bird in the hand is worth two in the bush". During crises many investors tend to underestimate the risk of a successful turnaround and also underestimate the ability of quality companies to keep compounding shareholders wealth.**

Regards

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It seems that Greeks prefer rallies to working!