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Greece and the ECB - is the Eurozone crisis about to make a comeback?

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Key points

> While Syriza has won the Greek election, a Grexit is not the most likely outcome.

> Even if Greece were to exit the Euro, peripheral Europe is now in far better shape than in 2010-12 and Eurozone defence mechanisms are stronger.

> While the Euro likely has more downside, Eurozone shares are attractive reflecting relatively cheap valuations, the likelihood of stronger growth ahead and very easy ECB monetary conditions.

Introduction

With Greece back in the headlines after Syriza's election win, it's natural to wonder whether we are going to see a rerun of the Eurozone crisis that roiled global financial markets in 2010-2012. However, much has changed since 2012. This note looks at the main issues.

Grexit not the base case

While left-wing Syriza won the election with 36.3% of the vote and has formed a coalition Government with the conservative Independent Greece party there is a long way to go yet before a Greek exit (Grexit) from the Euro will occur, if at all. First, it's not clear how stable the new coalition will be, so another election cannot be ruled out. But assuming it holds, the next step is negotiations with the Troika of the IMF, EU and ECB that holds 80% of Greek debt regarding the ongoing debt support and reform program for Greece. Reaching an agreement could take months and will likely be the source of financial market volatility.

However, the likelihood is that an agreement will ultimately be reached. The Troika may be prepared to tolerate a slight softening in the Greek program, but not too much for fear of being seen to reward Greek voters and with the ECB embarking on QE the threat of a Grexit to the rest of Europe isn't what it used to be. Rather the pressure will mainly be on Syriza to compromise. Failure to reach an agreement will mean the end of Troika funding for Greece resulting in even worse austerity and the withdrawal of ECB support for Greek banks. The latter would result in an instant banking crisis, causing a renewed lapse into recession. In order to get elected, Syriza is no longer seeking to leave the Euro as it recognised that 70% of Greeks want to stay in. As the realities of Government dawn on Syriza leader Tsipras, a further softening in its stance is likely to clear the way for an agreement. But this could take months and entail some difficult moments. However, markets will just have to get used to this, as they have with the Ukrainian conflict.

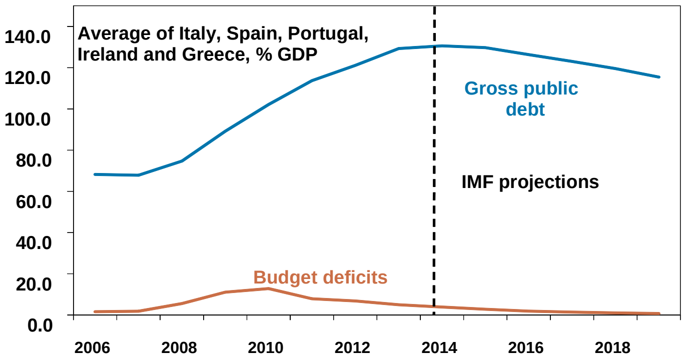
But even if there ultimately is no agreement thereby putting Greece on a path to exit the Euro, the threat of contagion to the rest of the Eurozone is far less than it was in 2010-12 as peripheral countries and defence mechanisms are stronger.

Stronger peripherals

Across a range of indicators, troubled Eurozone countries are in far better shape than they were when the crisis erupted.

- Budget deficits are coming under control in the main crisis countries. The average deficit in these countries was around 4% of GDP in 2014, versus 13% in 2010. This is set to see average public debt levels fall this year. Note the improvement is the same whether Greece is included or not.

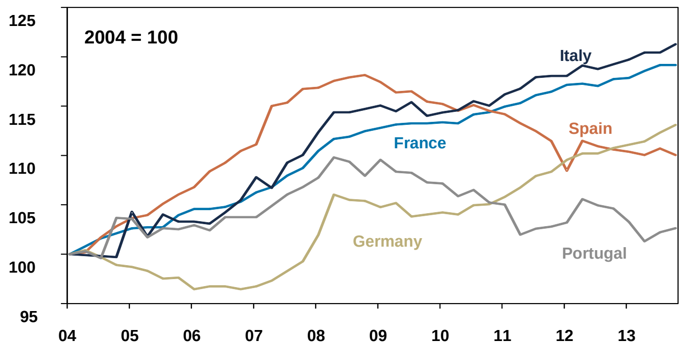
Budget deficits and public debt coming under control



Source: IMF, AMP Capital

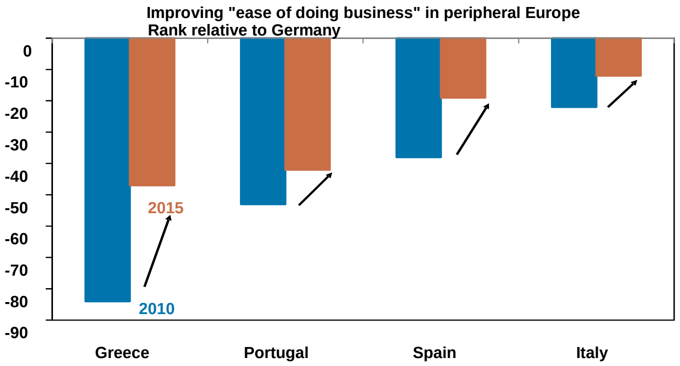
- Despite scepticism, economic reform has been underway. One guide is unit labour costs which reflect productivity growth and labour costs. Spain and Portugal have made significant progress in cutting costs relative to Germany.

Unit labour costs



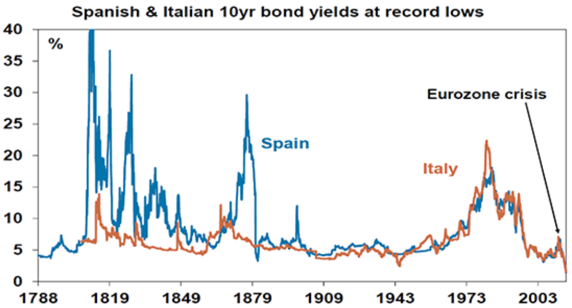
Source: OECD; AMP Capital

- Another guide is the ease of doing business. The ranking of peripheral countries relative to Germany in the World Bank's Doing Business Survey has improved significantly since 2010. Eg, Spain has gone from 38 countries behind Germany to now 19. Greece's improvement is even greater!



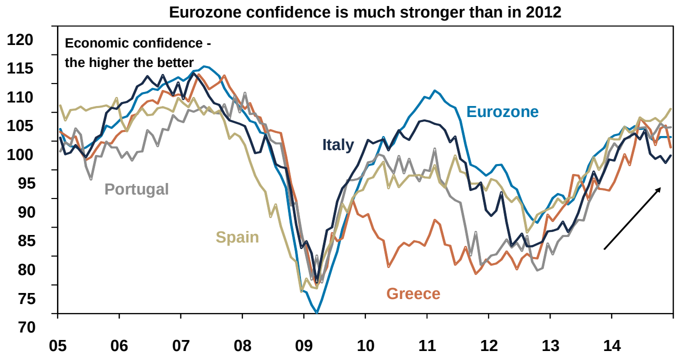
Source: World Bank, DB Global Markets Research, AMP Capital

- Bond yields in peripheral countries have collapsed to record or near record lows on the back of the ECB's action to do "whatever it takes" to prevent a break-up of the Euro.



Source: Global Financial Data; AMP Capital

- Finally, while it remains shaky, confidence and business conditions have improved across the Eurozone since 2012.

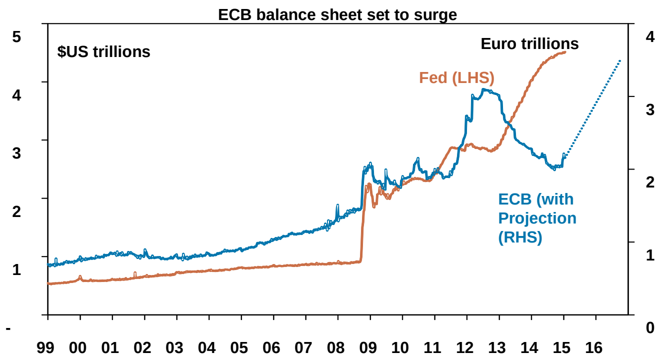


Source: Bloomberg, AMP Capital

So put simply peripheral Europe is far stronger and less vulnerable to a Grexit than it was in 2012.

Eurozone defence mechanisms are stronger

Supporting this, defence mechanisms to support troubled countries are also stronger in the Eurozone with a strong bailout fund, a banking union and a more aggressive ECB. Of these the ECB is most important. Its QE program – €60bn/month in debt purchases out to September 2016 or until inflation is back on track – was well above expectations.



Source: Bloomberg, AMP Capital

The ECB is now set to expand its balance sheet beyond the 2012 level – or €1trillion of QE – that President Draghi last year implied was the objective. With public debt now included there is little doubt this can be achieved. And the open ended nature of the program puts it on a par with the Fed's successful QE3 program. As in the US, it is expected to work by boosting inflation expectations, displacing investors from low risk assets into higher risk assets and so boosting the availability of capital and asset values, helping support bank lending and via a lower than otherwise Euro.

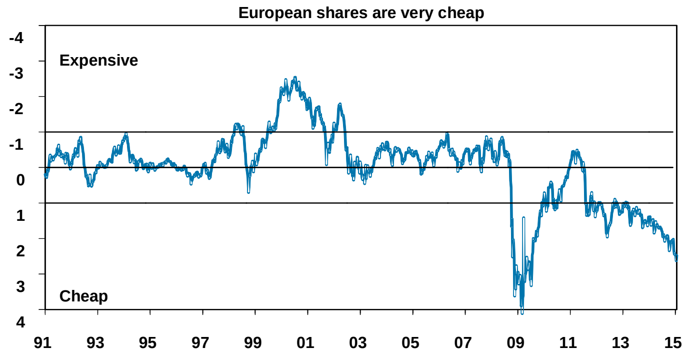
All of this should help ensure that deflation will not be sustained in the Eurozone and that growth will get back onto a firmer footing. And it helps back up the ECB's commitment to keep the Euro together even if a weak member like Greece "decides" to exit. This is good news for the global economy.

A boost to more radical anti-Euro parties?

No doubt Syriza's victory will fuel fears of a shift to more radical parties in Europe. This is certainly worth keeping an eye on and highlights the need to speed up the recovery and push unemployment down faster. However, Greece aside, it's surprising that after six years of pain non-centrist parties haven't done much better. Spain is really the country to watch given the meteoric rise of far-left Podemos, but its election is not until December and by then support for Podemos may have faded if Syriza achieves little/makes things worse in Greece.

Overweight Eurozone shares

So while the change of Government in Greece could result in short term uncertainty, overall we don't see a return to the Eurozone crisis. More broadly, there is a strong case to overweight Eurozone equities. First, they are relatively cheap. The next chart shows a composite valuation measure for European shares that indicates they are more than 2 standard deviations (or more than 20%) undervalued.



Source: Bloomberg, AMP Capital

Second, there is a good chance that growth in Europe will surprise on the upside in the short term thanks to: the collapse in oil prices; reduced fiscal drag as the worst of the austerity programs are behind us; the weaker Euro which will boost export growth; and as the ECB's QE stimulus hits at a time when private sector credit has already started to increase.

Finally, thanks to the ECB ramping up QE, monetary conditions are easing in Europe which is positive for shares from a liquidity perspective.

However, with the ECB easing monetary policy at a time when the Fed is gradually edging towards rate hikes, and Greece throwing in some short term uncertainty, the Euro is likely to fall further against the $US. Against the $A, the Euro may also slip a bit but with the RBA also set to ease further any fall here may be limited.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital