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MACROCOSM

Greece is Saved! (Again...)

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Lorcan Roche Kelly

Another version of another bail-out. Fortunately, we don't have to care anymore.

Market reaction to the Greek bail-out deal announced last night has been muted. All that it has done is make final -- or as final as anything can be concerning Greece -- the deal that was first announced last July (see "Whatever It Takes" July 22, 2011). That deal, with its requirement that private holders of Greek sovereign take losses, was a key catalyst to last year's summer of extreme volatility (see "2011: A Lost Year" December 29, 2011). With the deal now done, the S&P 500 has completed a round-trip back up to the level at which the deal was first announced (please see the chart below).

At this point, with almost two years passed since the very first Greek bail-out, all participants should have their direct Greek exposure under control. It is now the political reaction within Greece that will be the reaction worth watching, and the reaction that will generate the most headlines in the coming months.

Yesterday's agreement brings Greece another step closer to the end-game scenario we have envisioned for some time -- becoming a protectorate of Europe (see "Six Days to What" October 17, 2011). Every new bailout

Update to strategic view

EUROPE MACRO, ECB: Greece is becoming effectively a protectorate of the European Union, as we have long predicted. Political risks in Greece still remain, with left wing anti-austerity parties making gains in polls. An election victory for these parties in April will be a set-back. But there is no systemic exposure to Greece at this point -- from here, it should remain a side-show. It is next week's ECB 3-year LTRO that is the next key tactical inflection point for Europe.

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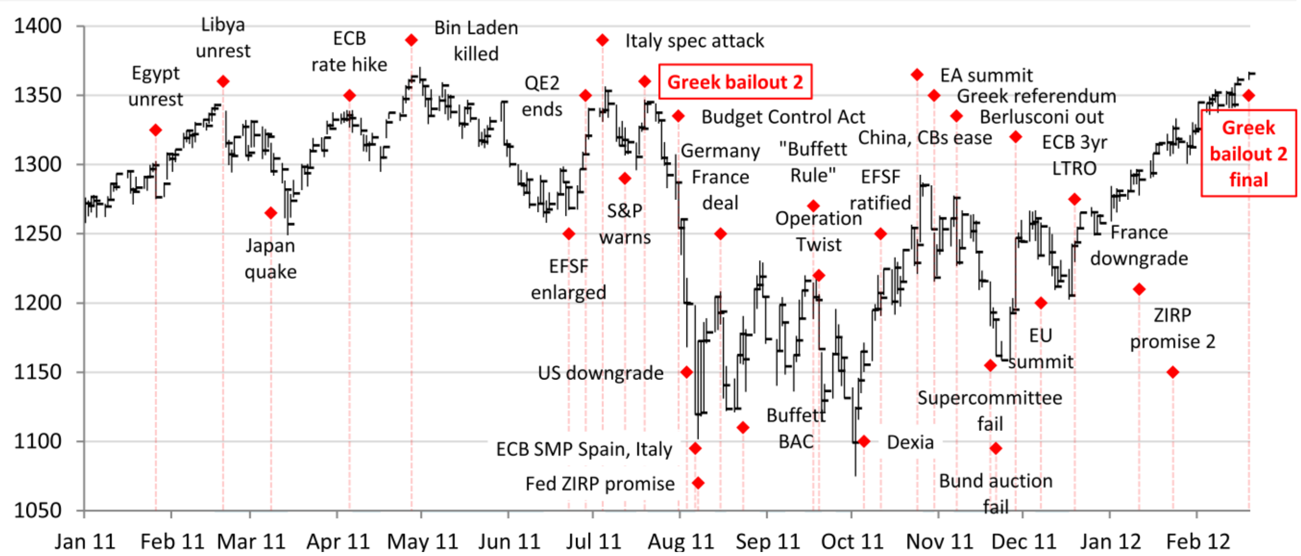
S&P 500 ◆ Event shocks Source: Bloomberg and TrendMacro calculations



agreement comes at a sovereignty cost to Greece, and the latest round exacts the highest cost yet.

- Under the agreement Greece will have reduced access to funding -- a segregated account is to be created to ensure that debt repayment is the top priority -- and very close supervision of spending, as Greece's European paymasters increase their presence on the ground, and do so permanently.
- While Greece's fiscal sovereignty had already been severely curtailed when it became a "'program country'" in 2010, the agreement reached last night calls for it to permanently cede its fiscal independence to its European partners.

This will be seen as a victory for the Germans and the Dutch, who have both expressed a need to have control over Greek finances in recent weeks. But long-term, the political reaction in Greece will be a risk.

- There is an election due in Greece in April -- date still unconfirmed -- which will end the technocratic government of Lucas Papademos. The latest polling shows that support for the two main parties -- PASOK, still lead by George Papandreou, and New Democracy, led by Antonis Samaras -- both of which have pledged support to the bail-out package, are coming under pressure, with both now below 20% approval.
- The big winners in the latest polls are the parties of the left, who have always opposed austerity measures. A coalition government in Greece that is dominated by these parties will most likely try to renegotiate the bail-out. It is very unlikely that Greece's European partners would have any patience with such moves.

For the record, the measures announced yesterday will look very familiar to the measures announced last July (again, see, "Whatever It Takes").

- The troika (EU/IMF/ECB) will make funding of €130 billion available to Greece across the period of the program -- which is expected to run until 2014.
- The interest rate charged on funding provided by both the current and the previous bailout package has been cut by 50 bp across the lifetime of the packages.
- The private sector involvement (PSI) haircut on outstanding debt has been increased to 53.5% of the nominal value of bonds held, from the 50% that had been agreed last October. Charles Dallara, director of the Institute of International Finance (IFF) said this haircut would lead to a net present value loss of over 70%.
- There has been small-scale central bank involvement. National central banks in the euro area that hold Greek bonds in their investment portfolios will give any profits on these holdings back to Greece, via their national governments. As the NCB bond holdings are not included in the PSI negotiations, they are expected to pay at par, thus potentially yielding a gain. Speaking at the press conference last night, EU economic affairs commissioner Olli Rehn

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suggested that any ECB profits on its Securities Markets Programme (SMP) purchases may also be distributed in a similar fashion, but this would be at the discretion of the strongly independent ECB.

- The Eurogroup (the committee of euro area finance ministers who announced the agreement yesterday) also highlighted some of the structural reforms needed in Greece: an efficient tax system, effective public administration, more favorable business climate and allowing unit labor costs to adjust. These measures are now a familiar wish-list from European leaders (see "Europe's Supply-Side Revolution" February 17, 2012) -- feasible in Italy, Spain, Portugal and Ireland, but probably very hard to implement in politically volatile Greece.

For every element of the bail-out, implementation will be key. That said, we think Greece has become relatively unimportant as a source of systemic risk, and therefore unimportant as a strategic consideration for investors. The political risks are still high, so the risks of a messy default or an exit from the euro remain. But even German finance minister Wolfgang Schaeuble admitted recently that Europe is much better prepared now for a Greek default.

For investors, it is probably best to ignore the Greek headlines. The most important thing happening in Europe is the second -- and if press reports are to be believed, last -- 3-year LTRO from the ECB, the results of which will be announced on February 29 (see "On the ECB and BOE February Rate Decisions" February 9, 2012). This is where we will be focusing our attention in the coming days, not on continuing political brinksmanship in Greece.

Bottom line

Greece is becoming effectively a protectorate of the European Union, as we have long predicted. Political risks in Greece still remain, with left wing anti-austerity parties making gains in polls. An election victory for these parties in April will be a set-back. But there is no systemic exposure to Greece at this point -- from here, it should remain a side-show. It is next week's ECB 3-year LTRO that is the next key tactical inflection point for Europe.