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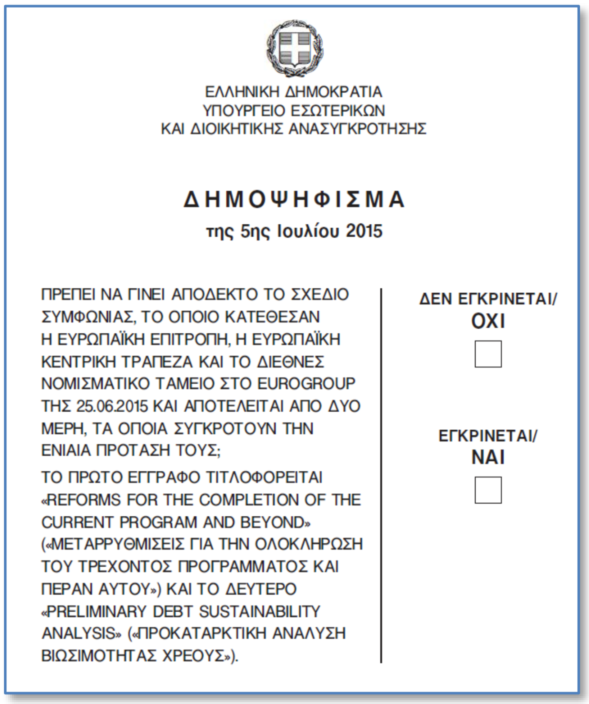
On the Greferendum "OXI" Surprise

Monday, July 6, 2015
Donald Luskin

Europe won't capitulate to this template for democratically justified default in Italy and Spain.

Greece's strong vote "no" (or in Greek, the politically resonant word *"OXI"*) in yesterday's referendum on Europe's bailout terms was not what we had expected (see "On the Greferendum Surprise" June 29, 2015).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ΔΗΜΟΨΗΦΙΣΜΑ
της 5ης Ιουλίου 2015

ΠΡΕΠΕΙ ΝΑ ΓΙΝΕΙ ΑΠΟΔΕΚΤΟ ΤΟ ΣΧΕΔΙΟ ΣΥΜΦΩΝΙΑΣ, ΤΟ ΟΠΟΙΟ ΚΑΤΕΘΕΣΑΝ Η ΕΥΡΩΠΑΪΚΗ ΕΠΙΤΡΟΠΗ, Η ΕΥΡΩΠΑΪΚΗ ΚΕΝΤΡΙΚΗ ΤΡΑΠΕΖΑ ΚΑΙ ΤΟ ΔΙΕΘΝΕΣ ΝΟΜΙΣΜΑΤΙΚΟ ΤΑΜΕΙΟ ΣΤΟ EUROGROUP ΤΗΣ 25.06.2015 ΚΑΙ ΑΠΟΤΕΛΕΙΤΑΙ ΑΠΟ ΔΥΟ ΜΕΡΗ, ΤΑ ΟΠΟΙΑ ΣΥΓΚΡΟΤΟΥΝ ΤΗΝ ΕΝΙΑΙΑ ΠΡΟΤΑΣΗ ΤΟΥΣ;
ΤΟ ΠΡΩΤΟ ΕΓΓΡΑΦΟ ΤΙΤΛΟΦΟΡΕΙΤΑΙ «REFORMS FOR THE COMPLETION OF THE CURRENT PROGRAM AND BEYOND» («ΜΕΤΑΡΡΥΘΜΙΣΕΙΣ ΓΙΑ ΤΗΝ ΟΛΟΚΛΗΡΩΣΗ ΤΟΥ ΤΡΕΧΟΝΤΟΣ ΠΡΟΓΡΑΜΜΑΤΟΣ ΚΑΙ ΠΕΡΑΝ ΑΥΤΟΥ») ΚΑΙ ΤΟ ΔΕΥΤΕΡΟ «PRELIMINARY DEBT SUSTAINABILITY ANALYSIS» («ΠΡΟΚΑΤΑΡΚΤΙΚΗ ΑΝΑΛΥΣΗ ΒΙΩΣΙΜΟΤΗΤΑΣ ΧΡΕΟΥΣ»).

ΔΕΝ ΕΓΚΡΙΝΕΤΑΙ/
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ΕΓΚΡΙΝΕΤΑΙ/
ΝΑΙ

- A "yes" vote would probably have made things easier, sending a chastened Greek Prime Minister Alexis Tsipras back to the negotiating table with hat in hand. Europe would have been able to negotiate from strength, not having to worry about the kind of market volatility we're seeing this morning as of this writing. But then again, with a "yes" vote the SYRIZA government might have fallen, leaving no one to do the negotiating.
- As it is, with a "no" vote, Tsipras comes to the table with what he claims is a "mandate." We almost think he secretly wanted a "yes" vote, as that would have given him political cover to turn away from the cliff he has been leading his nation toward. Now he has little choice but to march right over the edge -- after which it will matter little to his political future that he had a "mandate."
- Be that as it may, he will enter into negotiations with what his celebrity finance minister, game theorist Yanis Varoufakis, is crowing will function as an "ultimatum."
- Ironically, Varoufakis himself has turned out to be a political casualty of the referendum. He resigned last night, carping on his blog that he had been "made aware of a certain preference by some Eurogroup

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS, ECB, FX, US STOCKS: We didn't expect a "no" result in the Greek referendum. But it really changes nothing. Greece still has nothing more than a suicide threat coming into negotiations with Europe. Europe's position is strong, with only the long-term risks of "Grexit" at stake -- Greece faces immediately becoming a failed state. If anything, the referendum strengthens Europe's resolve to send the message that other indebted nations, especially Spain and Italy, cannot vote away their debt. While surprised by the referendum, we still expect a compromise, which would quickly resolve the present volatility as a buyable dip. Default to the ECB or "Grexit" would trigger a long-due 10%-plus correction in equities, but once the risks are resolved, that too would prove to be a buyable dip.

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participants, and assorted 'partners', for my… 'absence' from its meetings; an idea that the Prime Minister judged to be potentially helpful to him in reaching an agreement."

- Varoufakis, by citing what are in fact long-standing objections to him, means to give the impression that the Eurogroup was on the phone with Tsipras yesterday, reaching out to bring Greece to the negotiating table.
- But at least outwardly, Europe has if anything hardened itself. Shortly after the referendum results, Germany's Deputy Chancellor Sigmar Gabriel set the tone by telling the press, "with rejection of the rules of the eurozone...negotiations about a programme worth billions are barely conceivable." This morning Steffen Seibert, spokesman for Chancellor Angela Merkel, said, "the preconditions for entering into negotiations over a new aid programme do not currently exist," and quashed expectations that Merkel and French President François Hollande would come up with a new rescue proposal in their meeting today.
- Seibert did say that the door is "always open," but it seems that it is up to Greece to knock on it. Seibert said Berlin is waiting to see what Greece "places on the table."
- We think there are plenty of feasible compromises that can be negotiated. Both Tsipras and European Commission President Jean-Claude Juncker had already put out potential deals last week, before Merkel called a halt to any talks until after the referendum. Indeed, this morning French Finance Minister Michel Sapin said a "debate" on some form of restructuring Greece's debt is "not a taboo."
- The underlying truth here is that this is a "prisoners dilemma" that is in everyone's interest to solve cooperatively. Greece doesn't want to become a failed state (which, make no mistake, it would surely become), and Europe doesn't want to enter the realm of unknown unknowns beyond "Grexit."

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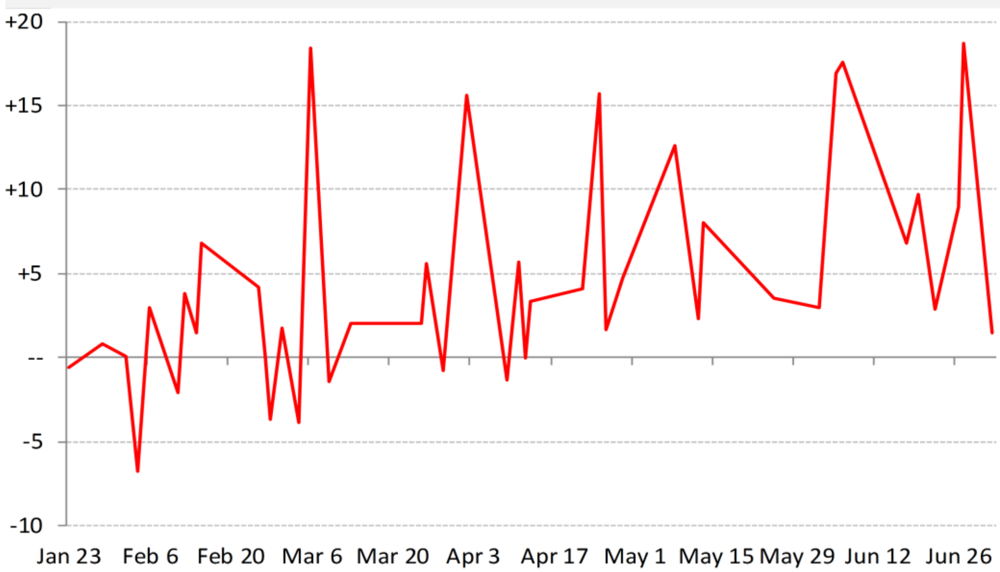
- *But Europe is in a vastly superior negotiating position. All it has at stake is risk -- considerable risk, to be sure -- while Greece is gambling with utter doom.*
- *Nothing has fundamentally changed in the negotiating dynamics. Varoufakis's so-called "ultimatum" is just game theory-speak for the same old suicide threat* (see "Greece at the Cliff: Thermopylae Edition" June 26, 2015)*. Whatever consequences a Greek debt default or exit from the euro currency now have after the referendum are exactly the same as they had before the referendum. The cliff is still the cliff.*
- *So it's fundamentally unlikely that Europe would make a mistake that would lead to what we see as the worst-case outcome -- a capitulation to Greece that incentives SYRIZA lookalikes in other euro area countries, launching a contagion of populist politics that would derail post-crisis reform. This would likely lead to a break-up of the euro currency, widespread debt repudiation and serial bank failures* (see "From Grexit to Griddance" February 23, 2015).
- We think the referendum -- and especially its "no" outcome -- has made it less likely that Europe will err by capitulating to Greece.
- The referendum made unmistakably visible the risk that electorates of debtor nations can be persuaded to adopt the philosophy that they can throw off the moral duty to repay simply by conducting a vote about it.
- Italy's Five Star Movement and Spain's *Podemos* -- both radical populists -- have actively campaigned for a "no" vote, with Podemos polling about even with the ruling *Partido Popular* of conservative reformer Mariano Rajoy (please see the chart below), and ominously calling the referendum "exemplary." American leftist crack-pot Paul Krugman -- now utterly discredited in European politics -- is a gushing SYRIZA admirer and "no" advocate. And Tsipras himself, in the rhetoric of his brief post-referendum victory statement, is pointing

Polling for Spain's 2015 general election: *Partido Popular* minus *Podemos*



Source: Wikipedia, TrendMacro calculations straight at Europe's populist nightmare -- using the word "democracy" five times (twice more than he used the word "the").

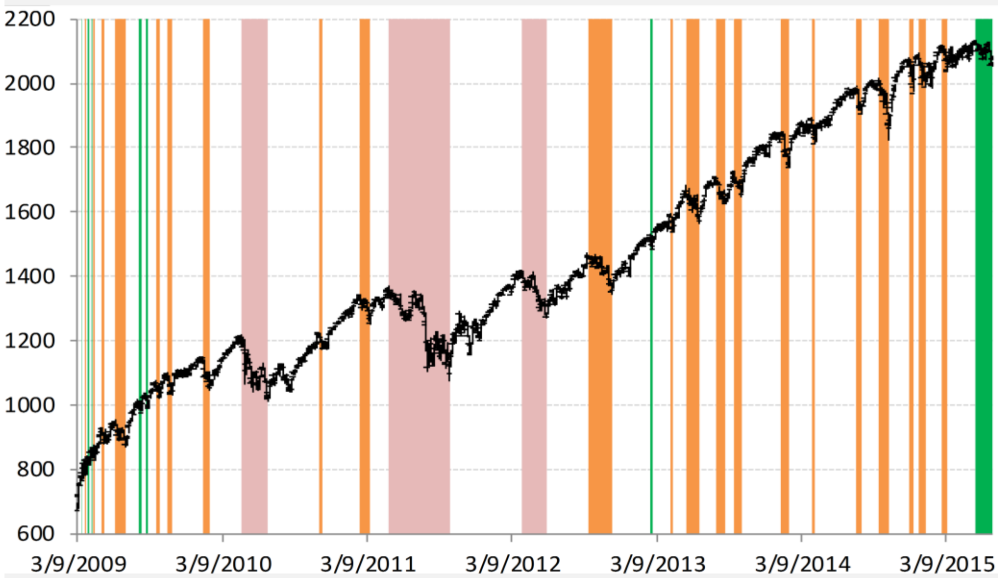
- We are reminded of the old joke: "democracy" is three wolves and a sheep voting on what's for breakfast. But this time, "democracy" is three debtors and a creditor voting on whether to default.
- *So we don't know exactly what Europe will do. But we can be pretty sure what it won't do. It won't establish a precedent that a European nation can vote itself out of its debt obligations. If that means setting the precedent that a nation can exit the euro currency, then so be it.*

As this week progresses, the pressure on Greece will increase. To be sure, the "no" referendum result shows that, perhaps, a week of bank closures and other economic pressures only served to stiffen the electorate's anti-Europe resolve. But we'll see what happens when the "no" vote fails to get the Greek banks re-opened by Tuesday -- they surely will remain closed without a compromise, though the capital controls regime put in place last week nominally expires.

While we wait for a negotiating outcome, global markets will continue in a long-overdue correction. Though we were first surprised by the referendum itself, and then again by the "OXI" outcome, it remains our baseline expectation that this period of uncertainty will be brief and will resolve well, producing yet another buyable dip.

- Obviously, if Greek default extends next to its obligations to the ECB, or if Greece exits the euro currency, then markets would have to endure a longer and deeper correction while the multiple uncertainties generated by these circumstances get resolved.
- Prime among these uncertainties is the blow to confidence that might arise of the ECB had to take a loss on its Greek sovereign bond

— S&P 500 March 9, 2009 through today, using futures prices as pre-open
■ Corrections between 3% and 5% ■ 5% to 10% ■ 10%-plus



Source: Bloomberg, TrendMacro calculations holdings of about €20 billion -- about €2.1 billion of which come due in two weeks -- and about €80 billion in Emergency Liquidity Assistance extended to the Bank of Greece. ECB Governing Council member Christian Noyer said this morning that the bond holdings cannot be restructured, because that would amount to "monetary financing" forbidden under EU rules.

- There would be much handwringing. But we think it will be another buyable dip. But we don't see how it wouldn't be enough to also be the first 10%-plus correction in US equities in what is today precisely 37 months (please see the chart on the previous page).

Bottom line

We didn't expect a "no" result in the Greek referendum. But it really changes nothing. Greece still has nothing more than a suicide threat coming into negotiations with Europe. Europe's position is strong, with only the long-term risks of "Grexit" at stake -- Greece faces immediately becoming a failed state. If anything, the referendum strengthens Europe's resolve to send the message that other indebted nations, especially Spain and Italy, cannot vote away their debt. While surprised by the referendum, we still expect a compromise, which would quickly resolve the present volatility as a buyable dip. Default to the ECB or "Grexit" would trigger a long-due 10%-plus correction in equities, but once the risks are resolved, that too would prove to be a buyable dip.