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Measuring Greek risk

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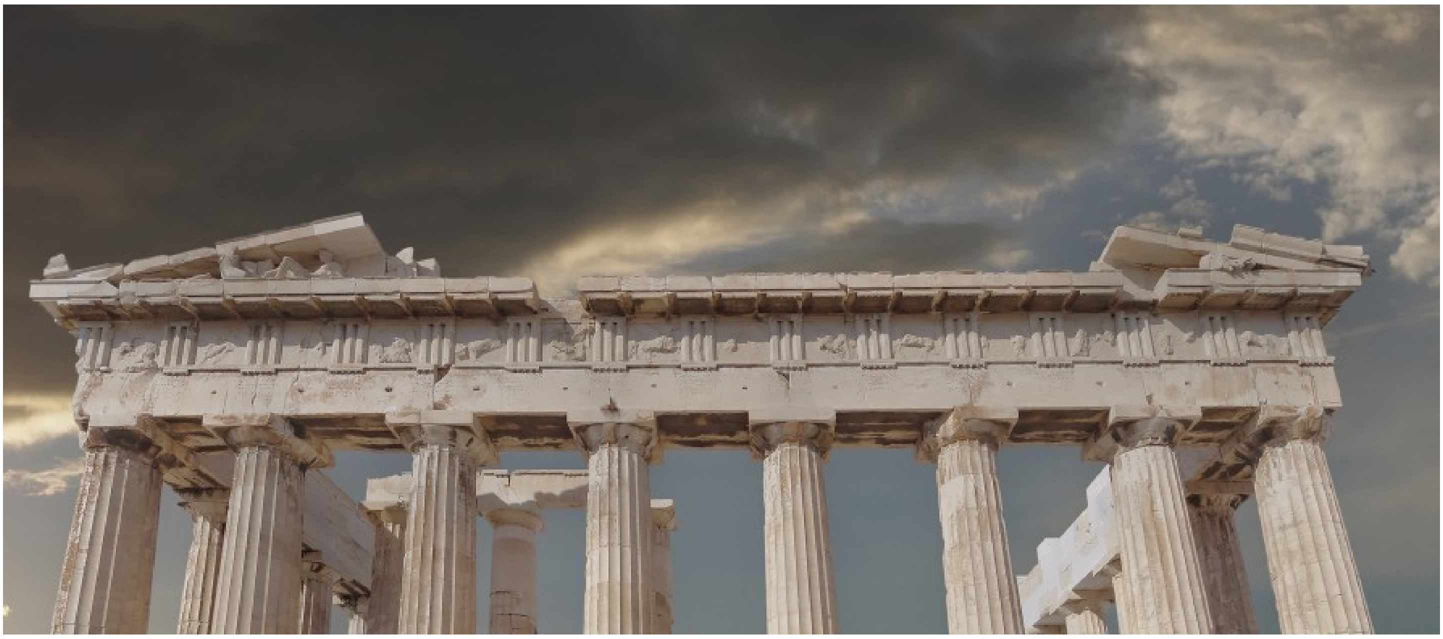

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The longest eleventh hour in recent history is drawing to a close. However, while the negotiations earlier this week seem to have narrowed the gap between Greece and its creditors, a final deal has not emerged yet.

How markets will react to Grexit in case a deal cannot be reached is mostly speculation, but at least we can assess how markets in the past few years were impacted by the ups and downs of Greece-related risk. For that purpose we calculated a simple risk indicator (GREEKRISK), by taking the spread of Greek 10Y sovereign yields over the average of comparable yields from Italy, Spain and Portugal. Thus, the general risk associated with peripheral Europe is (mostly) eliminated. The advantage of this approach over CDS spreads is that the latter show a much more hysterical trading pattern.

The chart below shows the history of GREEKRISK since 2009 and how it was affected by important political and economic events over this period:

*Source: Wikipedia; FT; Bloomberg; Erste Asset Management. *) Spread of Greek 10Y sovereign yield vs the average of SP, IT, PT*

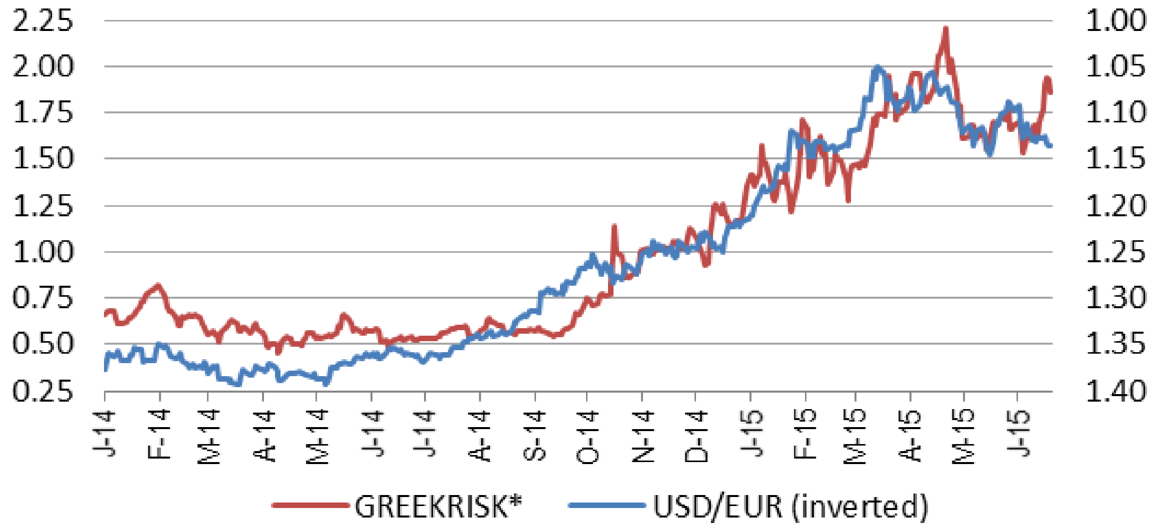
Legend:		
a) Pasok wins elections	h) PM resignation	o) Issue of Greek 3bn Eurobond
b) First austerity package	i) Debt swap	p) Snap presidential elections
c) First bailout	j) Election undecided	q) ECB QE announcement
d) New austerity	k) New Democracy wins election	r) Syriza wins election
e) 2011 budget approved	l) Draghi speech “Whatever it takes”	s) Eurogroup loan extension for 4 months
f) Portugal bailout	m) New austerity package	t) Postponement of IMF payment
g) Second GR bailout	n) Democratic Left leaves government	

The first thing to note is that our risk indicator which started moving up last autumn is still way below its peak during the last crisis. We are still not in panic territory, although yields above 10% clearly suggest that investors are worried.

The second aspect worth pointing out is how short-lived many achievements turned out to be. Bailouts only resulted in short-term downward blips, while some of what appeared to be bigger successes at the time faded away within few weeks or months (like the debt swap in March 2012 or last year’s return to international bond markets). Therefore, even if the parties succeeded in reaching a deal this week, hopes are slim that risks would not return later in the year. Gideon Rachman was (hopefully) wrong when he stated in the FT: “The truth is that whatever decisions are made, all choices could lead to chaos”

The connection between Greece-related risk and the Euro has been strong, at least since 2014, as the chart below shows:

Greek risk vs EUR



Source: Bloomberg; Erste Asset Management.
**) Spread of Greek 10Y sovereign yield vs the average of SP, IT, PT (rescaled)*

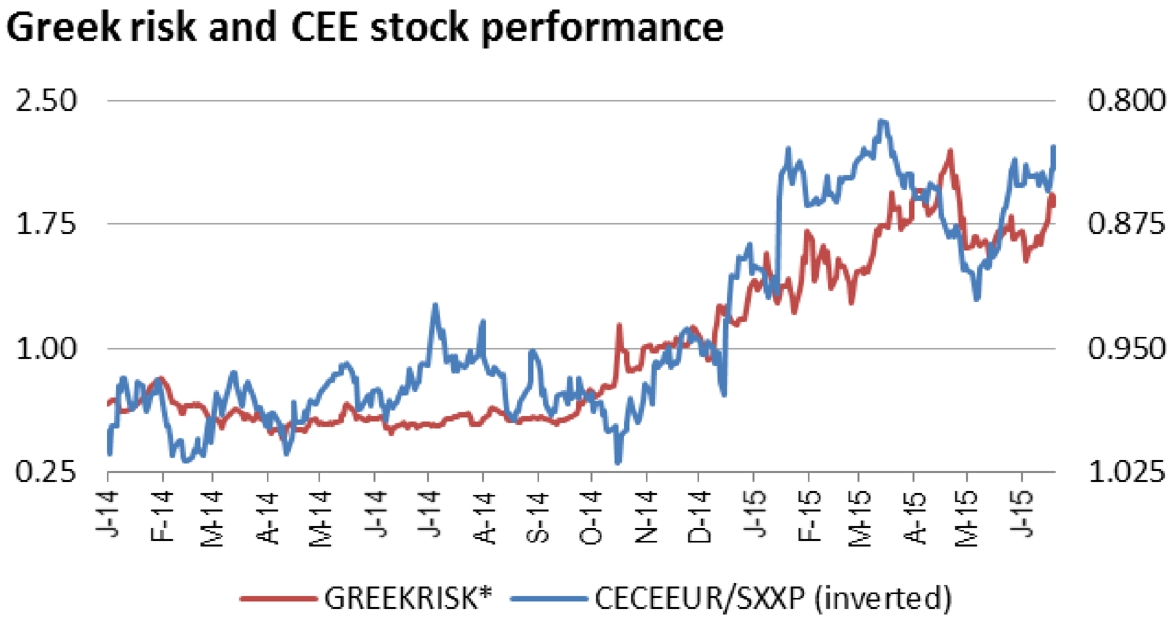
Correlation and causation are two different animals, of course, and the EUR is certainly not only driven by developments in Greece. Still, the chart suggests a remarkably strong relationship. The correlation coefficient was -0.96 since the beginning of 2014. Somewhat surprisingly, in June the Euro strengthened from 1.093 to 1.135 vs the US dollar, whereas the Greek risk indicator rose by 11%. Whether this reflected currency traders' belief that Grexit will not happen or the falling probability of a Fed rate hike before year-end remains unclear.

European equities obviously have suffered from the recent hike in Greece-related risks, as shown by the massive underperformance of the Euro Stoxx since April. Longer term, however, the link between European equities and developments is less pronounced and, occasionally, even the auspices of the relationship are are different from what one would expect. European equities started underperforming their EU peers in 2010 as the first signs of the Greek crisis emerged. When the situation stabilized in the second half of 2012, European stocks regained some of the lost ground. However, in 2013 their underperformance continued due to the emerging growth gap between the US and Europe – although risks in Greece improved.

Greek risk vs EU/US equity performance

Source: Bloomberg; Erste Asset Management.
**) Spread of Greek 10Y sovereign yield vs the average of SP, IT, PT (rescaled)*

In recent weeks, a lot of warnings have been issued concerning the potential fallout for CEE equities in case of a further deterioration of the Greek situation or even a Grexit. While the direct links between Eastern European economies and Greece are weak and mostly concentrated on Bulgaria and Romania, deteriorating investor sentiment and declining risk appetite could hurt the entire region. The fact that these warnings are not unfounded can be seen in the following chart which shows the relative performance of CEE to core European equities (inverted scale) vis-à-vis the Greek risk indicator:



Source: Bloomberg; Erste Asset Management.
**) Spread of Greek 10Y sovereign yield vs the average of SP, IT, PT (normalized)*

The situation is still fluid, to say the least. However, we still believe Grexit will be avoided – mainly for political reasons. First, the political will to keep the Union and the Eurozone together is immense (and has been constantly underestimated by US-observers in particular). Also from a narrow economic angle, the exit of a member would be problematic, as it would raise doubts about the Eurozone's durability.

Second, the fear of Greece moving into Russia's geopolitical orbit is spooking European and, particularly, US diplomats. It is time "to recognize that this is now not about the numbers. It is about the high politics of Europe", American economist Larry Summers wrote recently directed toward the IMF, but his plea applies to the other parties as well.

One things seems certain: Even if all parties take the right road – the ride will likely be long and bumpy.

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Peter Szopo has worked as chief equity strategist at the Erste Asset Management since March 2015. Before he already worked as a consultant for equity fund management at Erste Asset Management for Central and Eastern European equity markets. From November 2009 to April 2013, he was head of the research

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