GENERALI INVESTMENTS

Focal Point

Greece: No deal yet, but 2015-style crisis unlikely

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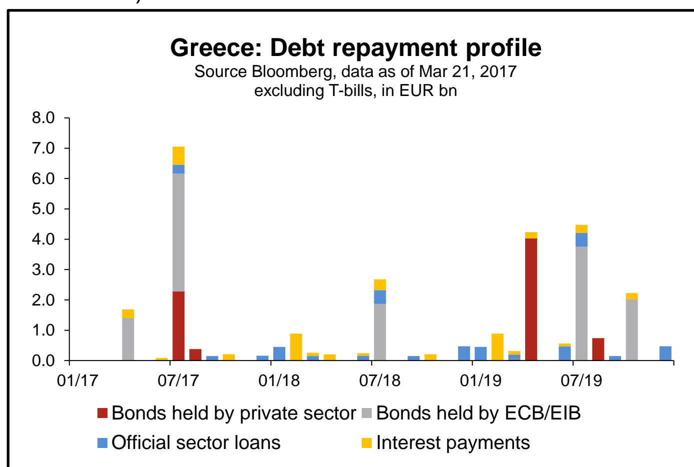
- Amid lack of sufficient reform progress, the Eurogroup on Monday called for an intensification of negotiations in order to complete the second review of the third Greek bailout program well ahead of the large redemptions in July.
- While an agreement over a more growth-friendly tax policy mix seems within reach, the Greek government keeps resisting the IMF's requests on labor market regulation and pension cuts. In addition, the IMF wants a clear commitment by European lenders to debt relief measures before rejoining the programme with a contribution of up to € 6 bn.
- Despite these difficulties, we expect a deal to be reached by the end of May. PM Tsipras lacks the support to call a public consultation, a step which triggered the escalation of the crisis in 2015.
- The completion of the review may well lead to the inclusion of Greek bonds in the ECB's QE program after July. Greek equities can benefit from falling spreads, the economic recovery and gradually healing banks' fundamentals.

One month after the promising Eurogroup meeting on February 20, the euro area finance ministers convened again on Monday this week to discuss the state of the negotiations over the second review of the third Greek bailout programme. Despite the constructive comments made by Greek representatives over the recent weeks, the press statement of the Eurogroup meeting only included a declaration of intent by the Greek authorities and the institutions to intensify talks in order to achieve a swift conclusion of the staff-level agreement. This is a required step to close the review and to unlock the € 6.1 bn worth aid tranche needed to meet the large redemptions coming due in July (€ 7.0 bn, including almost € 2.1 bn of privately-held bonds issued in July 2014, the last issuance made before the 2015 crisis).



Despite the ongoing impasse in the negotiations, we remain confident that a deal will be reached over the coming weeks. We will hereby analyze the still pending issues and describe the likely market developments under the assumption of a positive conclusion of the Greek review.

No fiscal gap amid budget outperformance

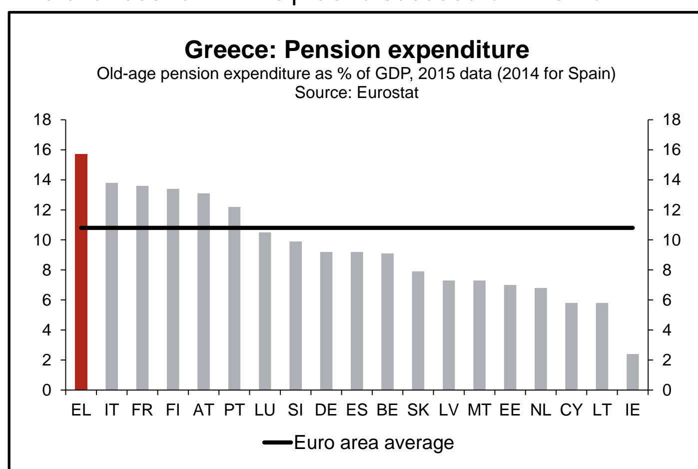
Before focusing on the key areas of disagreement, it is worth mentioning the achievements made by the Greek government so far. The most important one is the outperformance in terms of fiscal consolidation, which has helped to close the funding gap previously projected by the institutions for the 2018 budget (around € 550 million, or 0.3% of GDP). According to the provisional data by the European Commission (EC), the Greek general government's primary surplus rose to 2.3% of GDP at the end of 2016, outstripping the 0.5% target set in the memorandum. The EC expects the surplus to be maintained in 2017 (2.2% of GDP vs a target of 1.75%) and to increase further in 2018 (3.7% vs a target of 3.5%), although we deem the underlying growth forecasts (at around 3% in both years) to be too optimistic. The Eurogroup meeting on February 20 acknowledged this progress and stressed that any additional austerity measure would be offset by a budget-neutral expansionary one.

Another important step forward towards the completion of the review was the convergence over a new out-of-court settlement mechanism for non-performing loans. The latter amount to almost 50% of total loans when restructured NPLs are taken into account. Their rapid reduction is of paramount importance in order to revive economic growth.

Gridlock on labor market regulation and pensions

The list of issues still under discussion remains a long one though. Pension cuts and labor market regulation are the two most important areas of disagreement.

In the Article IV Consultation report published in February, the IMF affirmed that the Greek pension system remained highly imbalanced, with a deficit close to 11% of GDP, four times the euro area (EA) average of 2.5%. Also Eurostat data provide a bleak picture. Old-age pensions amounted to 15.7% of GDP in 2015 compared to 10.8% in the EA, even after a 10.3% reduction in nominal terms since 2009. The institutions want Greece to reduce its pension spending by 1 pp of GDP by 2020, but the Greek government would like to phase in the cuts between 2020 and 2022, i.e. only after the next general elections in 2019. We see little chances for PM Tsipras to succeed on this front.



Greece: Pension expenditure
Old-age pension expenditure as % of GDP, 2015 data (2014 for Spain)
Source: Eurostat

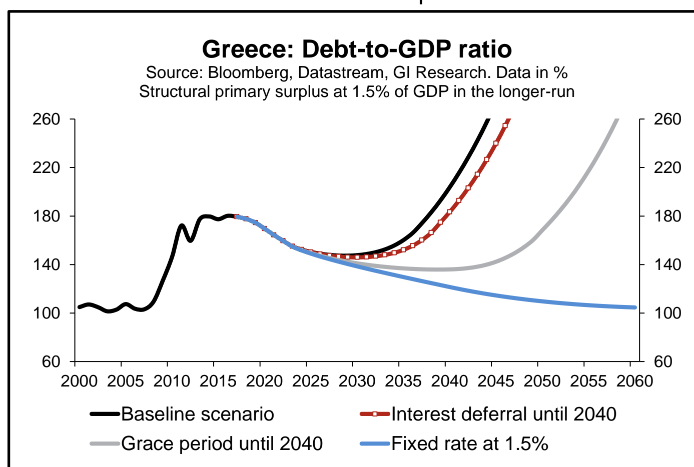
Labor market legislation is an even more complex topic. The IMF wants Greece not to reverse the earlier labor market reforms, including the abolition of the "National General Collective Labour Agreement" (EGSSE). The latter oversaw the minimum wage setting until 2012 and its abolition is considered by the IMF as a key driver of the successful internal devaluation occurred in recent years. On the other hand, Greece seems to have won the support of European lenders on the restoration of collective bargaining. The Eurogroup president, Mr. Dijsselbloem, and the EC Commissioner for Economic and Financial Affairs, Mr. Moscovici, have recently backed this position, opening a rift with the IMF. We believe that the final compromise will foresee the restoration of collective bargaining but with a clearer governance compared to the past, in order to strengthen the link between wages and productivity.

Negotiations also focus on the liberalization of the energy sector and a more growth-friendly reshaping of the tax system. The latter should combine a reduction of the tax-free threshold for personal income and possibly reduced deductions with offsetting expansionary measures, like lower taxes on corporations (now at 29%) and property (ENFIA).

Strong commitment needed on debt relief

The completion of the second review is also delayed by the ongoing negotiations between the IMF and European lenders over a comprehensive package to ease Greece's public debt burden. While the boards of the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF) approved a first set of measures in January, the IMF clearly affirmed that the Greek debt remains unsustainable and called for much bolder actions.

We tried to replicate the scenarios depicted by the IMF in its last Debt Sustainability Analysis (DSA) and we come up with very similar conclusions. The debt-to-GDP ratio would decline to around 100% by 2060 only under a lengthening of the interest deferral and grace periods on EU loans until 2040 (from 2022 foreseen currently), coupled with a cap of no more than 1.5% on the interest paid on them.



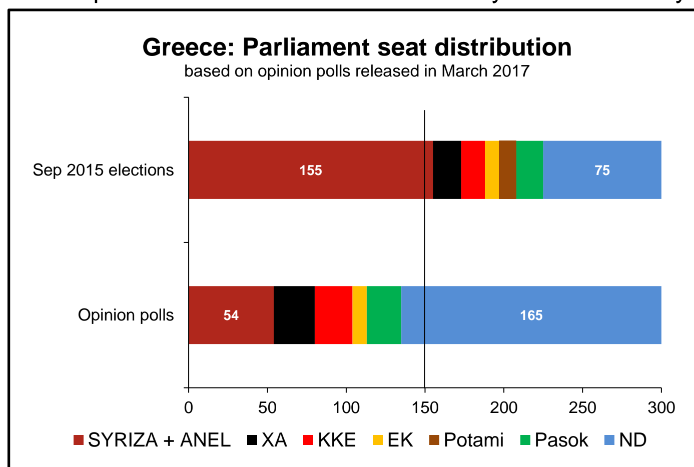
Greece: Debt-to-GDP ratio
Source: Bloomberg, Datastream, GI Research. Data in %
Structural primary surplus at 1.5% of GDP in the longer-run

European lenders have so far refrained from undertaking such a bolder step. At the same time, IMF's participation in the bailout program – with a financial contribution of up to € 6 bn – is tied to that. A compromise requires European lenders to strengthen their commitment to long-term debt relief measures. The latter would come into force only in 2018 and will be conditional on a swift implementation of the bailout terms by the Greek government.

Support for SYRIZA has plunged

Some commentators have claimed that the standstill in the negotiations could escalate into a full-blown crisis, leading Greece to the brink of euro exit as happened in the summer of 2015. We deem this little likely. When PM Tsipras called a referendum on the bailout terms, his party SYRIZA was leading in the polls with a 20 pp margin over the center-right New Democracy (ND). Now, the opposite is true. The latest polls show SYRIZA's support down to 18%, while ND is leading with 38%. Should snap elections be held today, ND would secure the absolute majority (165 seats out of 300), with SYRIZA down to just 54 seats.

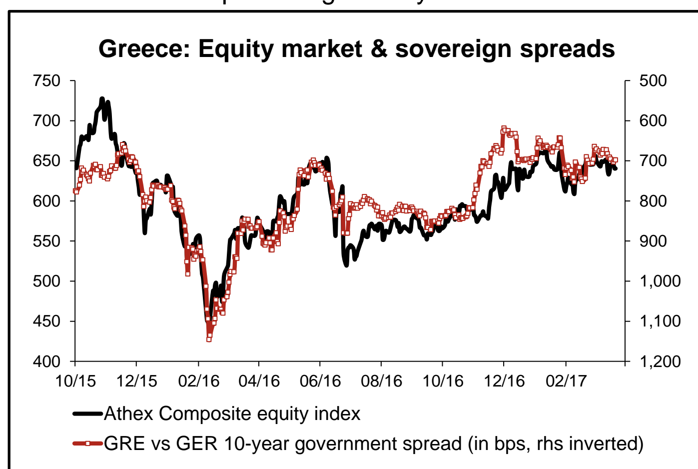
We consequently believe that PM Tsipras has no alternative but to abide creditors' demands. A staff-level agreement will likely require a few more weeks – a deal by the next Eurogroup meeting on April 7 looks difficult – and we now expect the review to be concluded by the end of May.



Greece: Parliament seat distribution
based on opinion polls released in March 2017

Scope for positive Greek assets return short term

The completion of the second review may well open the doors to the inclusion of Greek government bonds into the ECB's QE program. President Draghi recently affirmed that the ECB would consider the move once the European creditors and the IMF had agreed on the necessary debt relief measures, following also an independent assessment over the sustainability of the Greek debt. The inclusion in the QE program would be a crucial step to restore confidence and help Greece to regain market access. The ECB may start its purchases after the July's redemptions, i.e. when its holdings will fall again below the 33% issuer limit. While the amount of potential purchases under the QE program will be limited (just above € 2 bn), we believe that this could help reducing the spread over 10-year German bunds by around 100 bps (from 700 bps now), back to the levels prevailing in early December 2016.

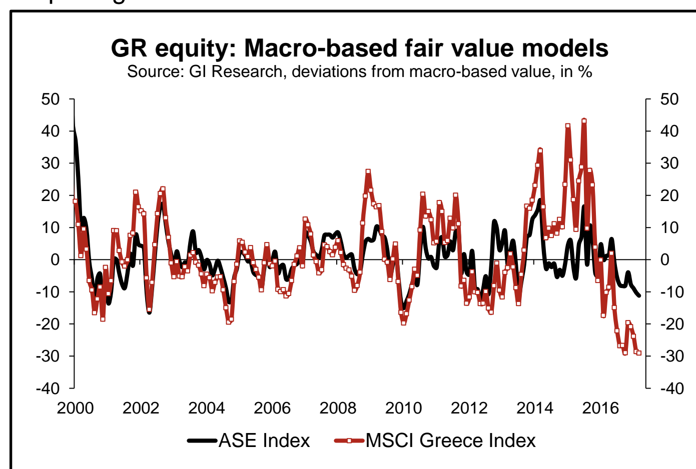


The Greek equity market underperformed the euro area (EA) year-to-date. The Athex Composite index declined by 0.5% compared to a 4.2% increase of the MSCI EMU. The MSCI Greece lost 8.8% due to its larger exposure to Greek banks. Lingering uncertainty over negotiations and renewed banks' deposit outflows were the key drivers.

The Greek market is characterized by a higher-than-average risk profile due to the low visibility on growth, political tensions and the large weight on banks. Its beta with respect to MSCI World is 1.4, as for Brazil and Russia.

Based on a long-term valuation approach, the market looks optically cheap, with a cyclically-adjusted P/E ratio – which uses a 10-year average for earnings – at around 2X (EA: 13.5X). Such low multiple, however, is the result of the earnings' collapse (-97%) experienced in the last 10 years, mirrored by the equity price performance. Based on the 12-month forward P/E ratio (currently at 13X), the market looks fairly valued.

On a shorter term horizon, the stabilization in economic activity (GDP down by 27% since 2007) should provide relief to earnings' growth. With real GDP likely to grow by around 1.5%, we anticipate profits to increase by an average of 10% this year and the next. Moreover, bank shares can benefit from the restructuring process, improved capital ratios and the likely stabilization of funding sources following the completion of the review, notwithstanding still high NPLs. An appraisal approach based on macro variables – nominal GDP, TARGET2 balance, 10-year Greek government bond spread over Bunds and oil price – suggests a more appreciable upside (see chart) compared to the one implied by the market multiple analysis. Taking also into account an expected 100 bps decrease in the 10-year government bond spread, we envisage a potential price appreciation of nearly 10% from current levels, based on the established relationship between sovereign risk premia and market movements in the last years. In the case Greek bonds are not included in the QE program, the upside potential for Greek equities would likely be more limited. Key risks to this outlook would arise from a political impasse – either at a national or European level – or by a surprising economic slowdown.



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