



## Focal Point

# Greece: Ready for the next challenges after bailout exit

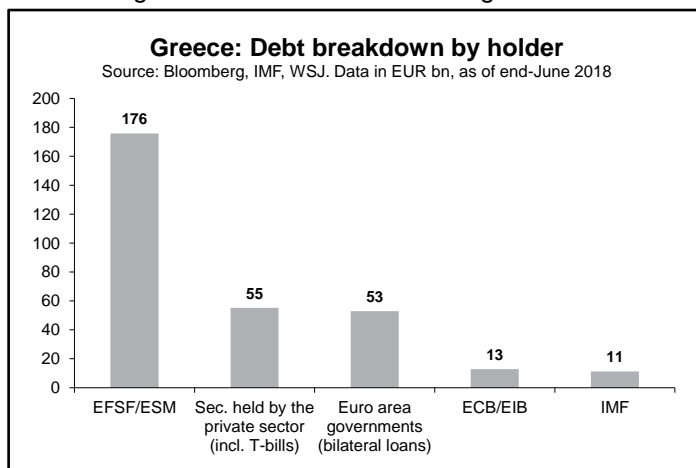
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**Authors: Luca Colussa / Michele Morganti**

- Greece successfully completed the final review of its third bailout program in June. The last aid tranche (€ 15 bn) will soon be disbursed, thus allowing Greece to build an ample cash buffer ahead of the program conclusion on Aug 20.
- On June 22, the Eurogroup also announced a new set of debt relief measures. They will substantially improve debt dynamics over the next decade, although longer-term sustainability remains subject to risks as noted also by the IMF.
- Looking at Greek assets, we remain confident on Treasury bills thanks to the very favorable redemption profile and high cash levels. Longer-dated bonds will likely remain volatile in the short-term due to negative spillovers from the Italian political woes, but they could benefit from further rating upgrades and the improved growth prospects.
- Greek equities have underperformed the EMU ones year-to-date despite the better earnings growth. Relative valuations have reached an attractive level and we recommend taking advantage of this, overweighting the Greek market.

After more than eight years and nearly €300 bn of disbursed funds by official creditors, Greece is eventually approaching the end of its third bailout programme. At the June 22 Eurogroup meeting, European leaders agreed on the positive conclusion of the fourth and last review of the programme, a necessary step to clear the way to the disbursement of the last aid tranche, worth € 15 bn. Moreover, they also announced a new round of debt relief measures aimed at improving the sustainability profile of the Greek government debt over the longer run.



In this report, we review the progress achieved by Greece so far, the expected developments after the programme expires and the key risks still in place. We then elaborate on the implications for Greek assets, trying to detect possible investment opportunities.

### A clean exit, but ongoing monitoring expected

As reported by many commentators, Greece's exit from the third bailout programme will be a "clean" one. This has two main implications. On one side, a clean exit means that no additional precautionary funding scheme will be in place after the expiration date (Aug 20) and that Greece will have to raise money on financial markets to meet its funding needs. On the other side, the lack of a precautionary scheme means that Greece will regain some room of maneuver, especially on the fiscal front. In order to reassure investors on Greece's commitment to fiscal discipline and to the structural reforms implemented so far, European leaders imposed conditionality on the implementation of the agreed set of debt relief measures.

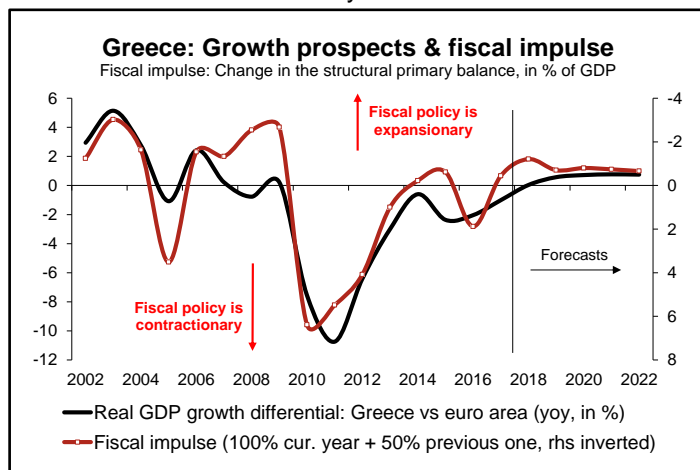
Firstly, the Boards of Directors of the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF) retain a relevant degree of discretion on the timing of implementation of debt relief measures. This is particularly important for the agreed deferral of interest and principal payments on EFSF loans by 10 years (amortization to start in 2033 vs 2023 before). The previous deferral scheme approved by the Eurogroup in December 2016 was implemented only one year later, in December 2017. Secondly, the other two debt relief measures agreed upon in June – the abolition of the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme and the transfer of SMP and ANFA profits (i.e. the two vehicles used by the ECB and the Greek central bank to hold Greek government bonds) to Greece – are subject to the implementation of policy actions and a strict monitoring by European institutions. Fi-

nally, the Eurogroup will assess whether new debt relief measures will be needed at the end of the EFSF grace period in 2032. Any additional action is subject to the continuation of the policy agenda over the next decade.

The scheme of incentives designed by European institutions should help reduce the risk of a significant policy shift both before and after the next general election, which may take place in spring 2019. In addition, it should be noted that PM Tsipras' party is trailing in the polls and that the center-right New Democracy is likely to regain the power. This would imply a confirmation of the pro-EU stance and a more market-friendly stance as New Democracy is proposing to cut corporate and property taxes. All in all, we see limited risks of a reversal of the structural reforms implemented so far, although some fiscal easing should be expected (as already factored in by EU institutions).

### Growth to outperform euro area average

The notable progress in fiscal consolidation and the structural reforms approved in recent years should lead to a sustained period of growth outperformance compared to euro area (EA) peers. According to the European Commission (EC), Greece had a structural primary surplus of 7.2% of GDP at the end of 2017, the largest in the EA. After an 18 pp adjustment since 2009, the EC expects the surplus to decline to 5.0% in 2019. This fiscal stimulus will support the incipient recovery. Real GDP expanded by 0.8% qoq in Q1, or 2.3% yoy, the fastest annual pace in a decade. We expect real GDP growth to hover slightly above 2% over the next five years.

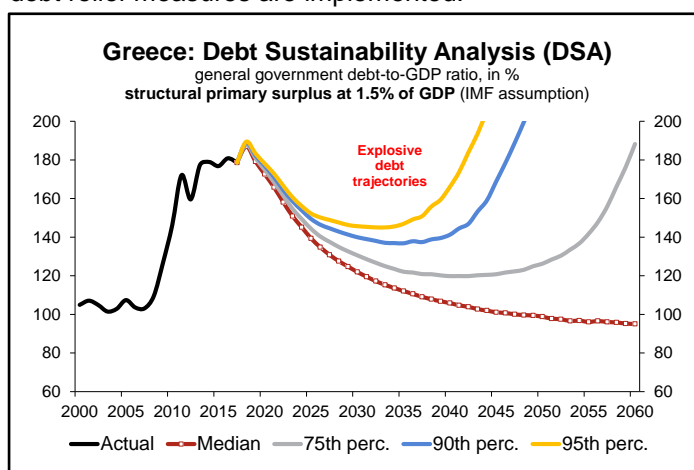


Another key area where Greece is expected to post a more convincing improvement is the banking system. After the huge capital outflows and the imposition of capital controls in mid-2015, banks have gradually reduced their reliance on central banks' funding. Emerging Liquidity Assistance (ELA) from the Bank of Greece declined to € 7.3 bn in June compared to a peak at € 86.8 bn in June 2015. Also, funding from the ECB (mostly via the Targeted Long-Term Refinancing Operations) is much smaller compared to other peripheral countries. Given this reduced reliance, the likely loss of the ECB's waiver after the end of the programme – Greek government bonds will not be eligible for refinancing operations anymore – is likely to have limited impact. In addition, deposit growth has resumed (+7.9% yoy in June), while the deleveraging process continued. There are still several issues though. Banks' non-performing exposure (NPE) – at € 92.4 bn in gross terms, or 48.5% of total exposure, in Q1 2018 – remains at ex-

ceptionally high levels and the IMF noted that banks may face a capital shortfall of €1.3-1.9 bn in an adverse scenario (up to 10% of the current capital base). The restructuring process will remain a lengthy one, but more decisive steps to address the NPE issue would foster the recovery in Greece, as happened in Spain, Ireland, Slovenia, and more recently in Portugal and Italy.

### Debt sustainability profile improved significantly

Several factors, including better growth prospects, high cash levels, lower funding costs and debt relief measures, have contributed to significantly improve the sustainability profile of Greek debt over the next decade. According to the EC, the gross debt-to-GDP ratio should decline from 188.6% in 2018 to 131.4% in 2030. The longer-term outlook remains more uncertain, with the EC being more optimistic than the IMF. The latter expects the debt trajectory to move again on the upside from late 2030s unless new debt relief measures are implemented.



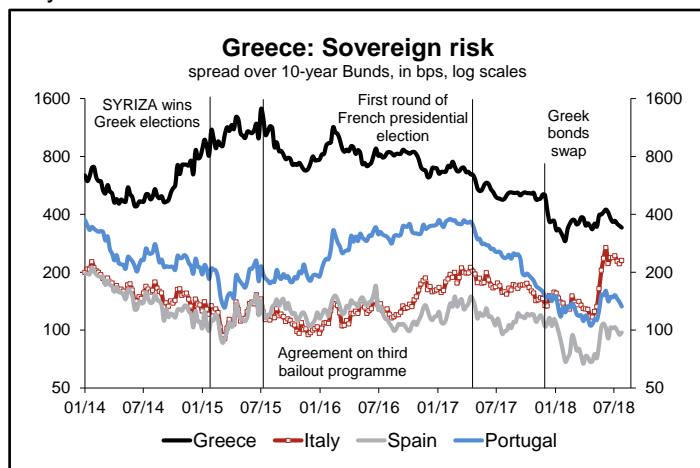
In order to have a better understanding, we ran our own Debt Sustainability Analysis, using Monte-Carlo simulations to assess also tail risks. Differently from one year ago (see [here](#) our Focal Point "Greece: No deal yet, but 2015-style crisis unlikely", released on March 24, 2017), we now deem Greek debt to be sustainable as long as a minimum primary budget surplus of 1.5% of GDP is maintained over the long run (the EC assumed a surplus of 2.2%). Of course, as noted by the IMF, the risk of explosive debt trajectories remains elevated, especially after 2032/33 when the amortization of EFSF and ESM loans will resume. Indeed, we expect gross financing needs to increase from an averaged 12.5% of GDP in 2018-2032 to 17.5% in 2033-2040 and a failure to reduce refinancing costs by that time would negatively weigh on the debt trajectory.

### Positive rating drift will eventually benefit GGBs

Considering the promising developments in the Greek economy and the existing risks, we reviewed the recent performance and the attractiveness of Greek assets, in order to detect possible investment opportunities.

Greek Treasury bills (GBTs) kept performing well. The yield of 3-month notes fell from around 2% at the end of 2017 to less than 1%, being barely affected by the negative spillovers from the Italian political woes. Given the very light redemption profile and the high cash buffers – Greece has enough cash to meet its financing needs until the end of 2020 – we remain confident about an ongoing positive performance of GBTs in the foreseeable future.

Also Greek government bonds (GGBs) have outperformed their EA peers year-to-date (ytd), with the 10-year spread over Bunds down from 370 bps at end-2017 to around 350 bps as of late. However, volatility has been high, with the yield differential falling below 300 bps in February (the lowest level since March 2010) to above 450 bps in late May due to the tensions on Italian BTPs.

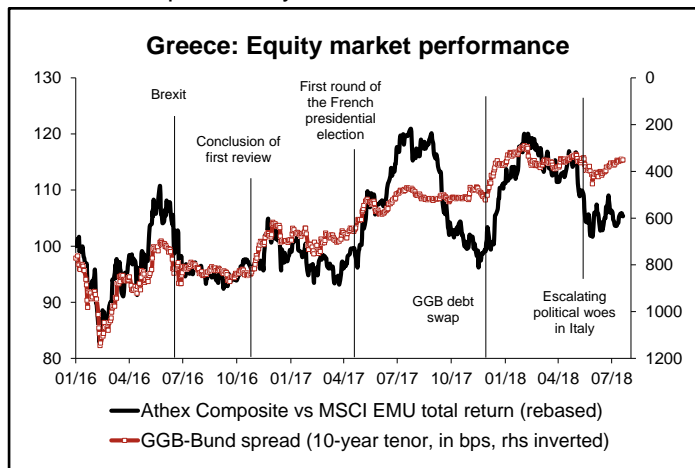


Looking ahead, GGBs will likely remain subject to volatility in the near term as we expect renewed pressure on BTPs in the run-up to the presentation of the budget law in Italy (late September). In addition, the systematic component (designed to track co-movements across EA country spreads) is unlikely to be supportive, as the ECB will reduce its support to the EA government bond market and stop purchases by year-end. That said, idiosyncratic factors are likely to support GGBs further down the road. In particular, our internal sovereign rating model points to further scope for rating upgrades by official agencies. Greece was upgraded twice by S&P (from B- to B+) and once by Moody's (from Caa2 to B3) and Fitch (from B- to B) in H1 2018 and all the three agencies assign a positive outlook. We do not expect Greece to achieve the Investment Grade status anytime soon (this is a key pre-condition for GGBs to be included in the ECB's QE program), but an improvement in the credit profile would anyway be well received by investors. In addition, GGB supply is likely to remain relatively limited over the coming years and the scarcity effect could also contribute to a further spread tightening.

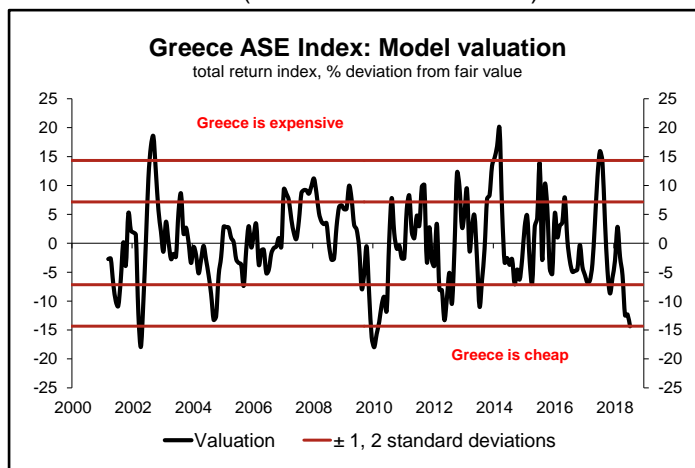
### Progress in macro adds to low equity valuations

Contrary to GGBs, Greek equities have underperformed the EMU ones ytd in total return terms (MSCI Greece down by 6.4%, MSCI EMU up by 3.7%). Such underperformance happened notwithstanding better earnings revisions (+11.3% vs. +5.6% ytd for the 12-month earnings estimate). Part of this underperformance can be attributed to the negative spillovers from the political situation in Italy. In particular, higher sovereign and financial bond spreads weighed on Greek equities. Financials represent 46% of the MSCI Greece index or 26% of the broader Athex Composite one. The uncertainty surrounding global trade frictions could have also played a role, as the Greek indices have higher-than-average risk (the beta for the Athex Composite index vs the MSCI EMU is 1.4). Having said this, Greece is exiting the programme in a stronger position and with substantial cash buffers. Moreover, the Greek economy is set to accelerate at a time when global growth has likely reached its peak. This is supportive for

Greek corporate earnings growth, too. At the same time, rating upgrades can lead to a reduction in the cost of capital for Greek firms. Finally, while it is true that Greek banks are pressured by high NPEs, the latter have started to decline and the deposit base is strengthening, contributing to further mitigate the risk on Greek banks. Possible capital increases can dilute banks' equity prices initially, but would then benefit them thanks to the positive impact on lending volumes and profitability.



Moreover, equity valuations look quite attractive in relative terms. Market multiples show a discount of 8.9% to history versus a 9.3% premium for the EMU index. Furthermore, the price momentum vs. the sovereign spread trend looks oversold (by 10% at least). This is also confirmed by our value indicator (based on earnings and risk-free rate trend, signaling a 30% upside) and our regression model, based on macro variables (current discount of 15%).



Lastly, Greek Shiller PE's (a very long-term approach to valuation as a 10-year average for earnings is used in the denominator of PE), looks very extreme in a global comparison at 2X vs. 16X for EMU. In sum, both macro and micro recent developments represent positive triggers for Greek equities at the time when relative valuations have reached an attractive level. We therefore recommend taking advantage of this, overweighting the Greek market, preferring the Athex Composite index as it has a lower exposure to banks if compared to the MSCI Greece one. In the short term, the main risk comes from possible negative spillovers from the political situation in Italy. That said, given the progress achieved by Greece in terms of debt sustainability and the better growth prospects, we deem potential setbacks as opportunities to consider an increase in the exposure to Greek asset classes.

# Imprint

**Head of Research** Vincent Chaigneau (vincent.chaigneau@generali-invest.com)

**Head of Macro & Market Research:** Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

**Team:** Luca Colussa, CFA (luca.colussa@generali-invest.com)  
Radomír Jáč (radomir.jac@generali.com)  
Jakub Krátký (jakub.kratky@generali.com)  
Michele Morganti (michele.morganti@generali-invest.com)  
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)  
Dr. Martin Pohl (martin.pohl@generali.com)  
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)  
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)  
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)  
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)  
Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)

**Issued by:** Generali Investments Europe Research Department  
Cologne, Germany · Trieste, Italy  
Tunisstraße 19-23, D-50667 Cologne

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<b>In Italy:</b>	<b>In France:</b>	<b>In Germany:</b>
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Corso Italia, 6 20122 Milano MI, Italy	2, Rue Pillet-Will 75009 Paris Cedex 09, France	Tunisstraße 19-23 50667 Cologne, Germany
Via Niccolò Machiavelli, 4 34132 Trieste TS, Italy		

[www.generali-invest.com](http://www.generali-invest.com)

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