

The Drachma Builds

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What is happening?

On Sunday 17th June the Greek people head to the polls for the second time in over a month to vote for a new government. The global community is turning this election into a referendum on Greece remaining in or leaving the Eurozone. As a result we are viewing this as a binary event. Either vote for a continuation of the existing austerity plan and stay in the Eurozone or vote for the radical left and possibly leave. If the latter happens then Greece will be the first country to leave the currency bloc, it would likely cause the economy to fall into a deep depression as Athens returns to a de-valued drachma and it could cause global market volatility akin to the Lehman Brothers bankruptcy in 2008.

What to watch out for:

The two main parties in the running to win the election are Syriza, a radical left party that is pledging to scrap austerity and keep Greece in the Eurozone. The second party is New Democracy, a conservative party who signed the moratorium prior to the May election to commit to austerity after the elections.

The latest polls suggest that New Democracy has a slight lead, with between 23-29% of the vote, while Syriza could get between 22 and 27% of the vote. Syriza won 17% of the vote in the May election, leaving it in second place; however its power base has strengthened considerably in recent weeks.

The winning party needs to get 151 of the 300 seats in the Greek Parliament to have an overall majority. If neither Syriza nor New Democracy get a majority then the Constitution in Greece allows a third election to take place.

Timings:

10 million Greeks head to the polls on Sunday 17th June

1900BST: voting ends and the exit polls will be released.

From 2130BST: the official results will be released

18/19th June: G20 meeting held in Mexico

Global coordinated policy response:

It's not just the Greek election that investors need to watch out for. There is a G20 meeting on Monday/Tuesday 18/19th June directly after the election where global central bankers could act to prop up the markets in an adverse outcome to the Greek election. There is also an EU Summit at the end of June where expectations are growing for European officials to take substantial concrete action to radically alter the currency bloc and foster greater fiscal union.

Thus, even in a worst-case scenario where Greece doesn't vote for a pro-bailout party and its future in the currency bloc hangs in the balance, global policy makers could step in with emergency measures and limit the downside for risky assets.

What could the G20 do?

- We believe the G20 would only act if there is a chance the Eurozone could implode (i.e., Greece leaves and market confidence nose-dives, causing a jump higher in Spanish and Italian yields, maybe even dragging France into the fray).
- Essentially global policy makers can only take remedial action – structural change has to come from Eurozone members. The actions the G20 could take may thus be limited to large-scale purchases of European sovereign debt to try and reduce credit risk especially for Spain and Italy, or boosting funds for the IMF in case Spain or Italy need a sovereign bailout.
If it looks like Greece may have to leave the currency bloc, then G20 members may set up a fund for Greece to try and help it through the painful adjustment of going back to the drachma.
- Although the G20 can't change the structure of the currency bloc it can pressure Germany and other EZ members to create a fiscal and political union, pooling of funds and also allowing the ECB to become the lender of last resort.

The EU Summit:

- This summit could see the foundations being laid for closer fiscal union in the currency bloc that would essentially mean the pooling of funds, including debt and a centralised tax collection service. This could pave the way for a banking union (and a region-wide bank recapitalisation fund) and then lead to the ECB taking a much bigger role in the currency bloc, which may include it becoming the lender of last resort. These measures would alter the history of the currency bloc, turning it into a United States of Europe.

The Greek election and the potential market reaction:**Scenario 1: New Democracy wins and there is no policy response at the G20 or EU summit.**

Outcome: The Euro, European equities, US equities all experience a sharp relief rally in the short-term. However, in the long-term gains are capped as sovereign solvency remains a concern in the currency bloc, and structural change is yet again kicked down the road until another crisis flares up. Thus, a short-term rally may lead to long term pain, and investors may sell risky assets on rallies. EURUSD could get above 1.2750, a

key resistance level, but the euro bears may go on the attack the closer this cross gets to 1.30, which could precede a move back towards 1.25 then 1.20.

Scenario 2: Syriza wins the election and there is no policy response

Outcome: This is perceived as the worst situation for the markets as it would increase the chances of a disorderly Greek exit and contagion spreading to Spain and Italy. We could see these two countries require bailouts in the coming days as a result of a giant surge in their borrowing costs. This could push EURUSD below 1.20. It may also cause a spike in volatility causing global stock markets to crash as investor confidence tumbles and the threat of global recession gets priced into the markets.

Scenario 3: Syriza wins/ a coalition is formed, but global authorities act to prevent a disorderly exit for Greece and the EU authorities agree structural change at the EU summit at the end of June

Outcome: This would be the best long-term outcome for the markets (apart from the Greek markets), in our view. Although there may be an initial sell-off on the back of the election results, the downside would be limited by the cushion provided by global central bankers. This firewall would include a road-map for an orderly exit for Greece, which would free up financial and political resources to protect Greece.

We believe this outcome would also include major structural change in the currency bloc and an extended role for the ECB to become lender of last resort. Thus, a move lower to 1.2200/ 1.2300 in EURUSD could then be proceeded by a rally towards 1.25 (post firm action at the EU summit at the end of June) and then 1.30 as investors digest the policy response (please see above for potential responses).

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