MARKET BRIEF
JUNE 2015

A GREEK TRAGEDY

This weekend the world learned that Greece is not going to make a scheduled $1.8 billion payment to the International Monetary Fund ("IMF") that is due on June 30th. Instead, Greece's Prime Minister, Alexis Tsipras, has given the nation a bailout referendum on Sunday July 5th, allowing citizens to decide whether to accept the austerity conditions imposed by the European Union and the IMF. A "No" vote could lead to Greece's exit from the European Union.

HOW DID WE GET HERE?

Greece is on the verge of default and needs another bailout to pay its creditors. According to Reuters, Greece owes €242 billion to the IMF, European Commission and the European Central Bank ("ECB"), with €17 billion in payments due in the next 3 months. Before providing any additional financial support, the European Commission has required Greece to make major spending cuts, raise the corporate income tax rate, increase its value added tax and raise the retirement age from 61 years old to 67 years old. While Greece desperately needs the immediate financial support, government leadership feels that these austerity measures will further depress economic activity in the medium and long-term. Greece is stuck between a rock and a hard place and either choice leads to a future of difficulty for the Hellenic nation.

IF GREECE VOTES TO ACCEPT TERMS

Greece benefited tremendously when they joined the European Union ("EU"). Their economy experienced significant growth and foreign investment increased on the back of the euro's credibility. Greece took advantage of low borrowing rates, which fueled its economic expansion. However, since the Global Financial Crisis of 2008, the Greek economy has sputtered. Since 2008, Greece's economy has declined by 25%, its unemployment rate has exceeded 25% and its youth unemployment has risen to greater than 50%. According to the American Enterprise Institute, Greece's recession has been on par with the United States' Great Depression of the 1930s.

By agreeing to its creditors' terms, Greece would commit to more austerity measures that would restrict economic growth. Complying with these terms would most likely push Greece back into a deep recession. Greece's debt load is extremely high, and further austerity measures would likely fail to bring debt-to-GDP levels down to more acceptable levels. Yet according to polls, even with these Draconian measures at bay, there appears to be enough support from the people to accept the terms. Most likely, this will result in the immediate ouster of Tsipras and his Syriza party, and we will have these same Greek exit conversations in another three or four years.

IF GREECE VOTES TO REJECT TERMS

According to Reinhart and Rogoff, Greece has defaulted on its debt seven times since 1800, more than any other developed country. Given this historical context, it seems plausible that Greece would default on its debt payment to its creditors. Under this scenario, Greece would be unable to issue sovereign debt and would therefore return to using the drachma currency. Greek banks would fail

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and capital controls would be imposed. The Greek government would devalue the drachma, thereby making Greek exports more competitive. However, this would also make imports more expensive for Greeks. In this scenario, Greece's economy would still plunge back into a recession; however, they would be able to inflate away some of their debt and eventually get back into growing their economy. Nonetheless, Greece's problems with tax avoidance and an unwillingness to "live within its means" would likely not go away. The Wall Street Journal recently estimated that at the end of 2014, Greek households owed their government €76 billion in unpaid back taxes, roughly 35% of GDP. Greece would also be barred from the capital markets and although they could print as many drachmas as they want, their debt burden would remain significant and would continue to limit economic growth. Greece would have a very hard time attracting foreign capital investment, and unemployment would likely remain in the high teens.

HIGHLAND'S VIEWPOINT
POTENTIAL IMPACT TO PORTFOLIOS

Europe is in a much better position today than it was in 2012 to handle either a Greek default or a Greek exit from the European Union. The European Union has a €500 billion European Stability Mechanism that can provide financing to any Eurozone member that could come under pressure. In addition, the European Central Bank has in place an Outright Monetary Transaction facility that allows the ECB to do "whatever it takes" to maintain market stability in the event of a Greek exit. However, the Maastricht Treaty, which was responsible for the creation of the European Union, made EU membership irrevocable. Therefore, allowing a Greek exit could substantially undermine the entire European Union and add considerable uncertainty to its future. Most likely, we will continue to see the U.S. dollar strengthen as investors look for safe haven assets until investors can determine if this crisis will trickle into other European periphery nations such as Italy, Spain and Portugal. There is a lot at stake for both Greece and Europe so all eyes will be on Greece next week.

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