Greece and the Eurozone

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On Thursday, 22nd January, markets were buoyed by the European Central Bank's (ECB) much anticipated quantitative easing (QE) announcement. The ECB has committed to buying a massive €60 billion worth of bonds and asset-backed securities every month until August 2016 with the aim of heading off deflationary pressures. However, only three days later investors were brought back down to earth by the news that radical anti-austerity left wing party Syriza had gained power within a coalition government in Greece.

The Eurozone

It is unclear whether QE itself will succeed in preventing a deflationary spiral in the Eurozone as bond yields and interest rates are already at historically low levels. What is clear is that the weakened euro (down by almost 17% from its 2014 peak versus the US dollar by the time QE was announced) is a positive for a trading bloc whose exports of goods and services account for 45% of GDP. This is significant both in terms of competitive advantage and in the translation of profits earned overseas back into euros.

The concurrent collapse in the price of oil (having more than halved from its 2014 peak dollar price) is also a positive for a region that imports most of its energy requirements. However, it should be noted that the weakness in the oil price also accounts for a significant proportion of the deflationary pressures faced by the region. From our perspective this is positive deflation and not to be feared; however, markets themselves are still undecided whether oil price weakness is a result of excess supply or a signal that the global economy is slowing. While we can't ignore China's slowing growth rate, there are good reasons to believe that the weak oil price is predominantly excess supply brought on by US tight oil (commonly referred to as "shale") and supply resuming from unlikely areas such as Iraq and Libya.

The risk of "Grexit"

While we are positive on European equities, what are we to make of the situation in Greece? There is no doubt that the election of Syriza has come as a timely reminder that deflation is not the only concern. Greece is heavily indebted with debt to GDP running at 175% (this compares to 91% for the UK). The austerity imposed on the country by the troika of the International Monetary Fund (IMF), the European Commission and the ECB has been described by economists as like the 1930s Great Depression in the US, just without the recovery. Real wages are 40% below their peak, unemployment stands at 25%, or as much as 50% amongst the youth.

Syriza have swept into power on an anti-austerity ticket whilst wishing to keep the Euro as their currency, which is viewed by many European countries as them wanting to have their cake and eat it. Why should Greece be offered debt forgiveness if it isn't available to all? Unsurprisingly this does not sit well with many countries, most notably Germany and Finland. Politicians have now had five years to consider the implications of Greece exiting, frequently referred to as "Grexit", and if anything they have become more resolved against debt forgiveness and have started to get more comfortable with what only a couple of years ago was the unthinkable, Greece leaving the Eurozone.

The implications of Grexit are not entirely clear. From a GDP perspective Greece accounts for 2% of Eurozone GDP and falling. If it had happened in the middle of the crisis the impact would have been catastrophic as the effects of contagion took hold, but today things are different. Undoubtedly markets would suffer short-term volatility but the risk of contagion would be much reduced: banks are in much better health today, and those that had high exposure to Greece have recapitalised and have benefitted from the ECB's purchasing of distressed sovereign bonds.

If Grexit does occur questions will arise about other heavily indebted countries such as Portugal and Spain. The risk is that the Eurozone may be viewed merely as a hard currency union that countries can leave as soon as they get in trouble, undermining the creditability of the currency. As for Greece itself, undoubtedly it would suffer hardship in the immediate term but beyond that one cannot know - perhaps it might thrive once unshackled from a currency union and a mountain of debt.

We don't have a strong view on the impact of Syriza coming to power, except to note that their rhetoric has softened as their power increased so their position and actual policies will likely develop over many months.

Investors have started the year underweight to European equities with very low expectations for growth within the region. The weakness in the currency is positive for the region and whilst quantitative easing can only help, it is hard to quantify the impact. Additionally, the weakness in the oil price should be a positive tailwind that helps both manufacturers and consumers alike. This leads us to be positive on European equities and we are currently overweight the region, with a bias towards multinational exporting companies where margins and earnings are still depressed compared to their peaks.