***OXI* to Austerity! Implications of the Greek Debt Crisis**
Causeway Research Note
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"I would like to see Greece as a case study, an opportunity for Europe to strengthen its coordination of fiscal policy."
-George Papandreou, former prime minister of Greece, 2009-2011

Unfortunately, the former Greek leader can now watch his country move from case study…to basket case. Even the Save Greece crowdfunding campaign (which raised €1.8 million toward the €1.6 billion goal) came up short. This year, with stronger bank balance sheets and central bank support, the contagion risk of depositor panic withdrawals seems unlikely in the rest of Europe. However, layers of bank regulations do not solve the underlying conundrum facing the euro zone (EZ). How do these 19 countries reconcile national sovereignty with the need to mutualize liabilities? The EZ economic unification process ramped up this past January 2015 with the official abandonment of the EZ's austerity-based monetary regime. In exchange, the European Central Bank (ECB) adopted extreme monetary liquidity as the region's economic salvation, led by the quantitative easing (QE) program of sovereign bond purchases on secondary markets. As evidenced by the recent Greek referendum "No" victory, long suffering voters may eventually reject austerity. QE cannot revive Europe without concurrent domestic reforms and fiscal stimuli. ECB president Mario Draghi argued at the annual central bank symposium last August in Jackson Hole that the EZ can only achieve sustainable economic recovery via coordinated fiscal and monetary policy, and the fiscal policy can only be coordinated across the region via Brussels. Headwinds to coordinated fiscal policy include a rise in leftwing populist political parties (such as Podemos in Spain, Five Star Movement in Italy, and Syriza in Greece). Populist governments (or, some would call them, demagogues) will likely gain power as long as European youth unemployment remains unresolved (an estimated 50% of Greek youth remain jobless), the flood of migrants (primarily from the Middle East and Africa) continues unabated, and Germany appears most influential in EZ policy. We believe that an end to the funding lifeline for Greece may ultimately become an important catalyst for greater European fiscal unity. However, a collapsed Greek banking system would fund itself via a new currency, with attendant spiraling inflation. Any government paying its bills (and pensioners) in worthless IOUs probably has a very short life—and such a collapse and crisis would reveal the populist deception to voters—especially those in Portugal, Spain and Italy. Austerity hurts, but capital controls and hyperinflation are far worse.

To review the changing situation in Europe, and highlight some of the opportunities in European banks, we spoke to Causeway portfolio managers Conor Muldoon and Alessandro Valentini. Alessandro recently met with ECB officials and several European bank managements to gauge the severity of the Greek crisis.

Q: Alessandro, how does the ECB view the deteriorating situation in Greece?

AV: The central bankers appear confident in their ability to prevent a spillover to other European countries. This confidence comes from the steps taken to ensure liquidity provided by the ECB in the quarters following the initial European debt crisis in 2011, the commitment of Spain, Portugal and Italy to restructuring programs, QE's beneficial impact to the EZ economy, and the limited exposure of banks and insurers to Greek government bonds and Greek collateral.

Q: How confident are you in the ECB's willingness to act as a backstop for the EZ?

AV: We believe the extreme events in Greece will lead to volatility in the markets, but should not lead to fundamental instability or a domino effect. Recent comments from the Eurogroup, finance ministers from the EZ member states, reinforce the message that they will take all means to ensure stability in case of a Greek exit (Grexit) or default. The concern that we hear from our clients is that losses would force the ECB to be recapitalized, which in turn would make it less likely to intervene in the future to mitigate any sort of adverse event. But, the ECB's balance sheet should be able to withstand more than simply a Greek default. The ECB has €98 billion in capital and reserves – that alone is a decent cushion given its Greek exposure. In addition, the ECB has €403 billion in "revaluation accounts." The ECB could use those unrecognized gains as a reserve against losses. Should an actual loss of, say, €100 billion materialize, the ECB's assets would decline by €100 billion, and its liabilities (via the revaluation accounts) would decline by the same €100 billion. Capital would remain the same €98 billion, and ECB recapitalization would not be necessary.

CM: If no deal is achieved and Greece chooses to relegate itself outside of the EZ, the ECB will be the first and most reliable antidote against financial contagion. In addition to stepping up the pace of QE, the ECB could provide liquidity to banks inside and outside the EZ, for example, via liquidity swaps with other central banks.

Q: What are the implications of a bond default and Grexit?

AV: The ECB owns the vast majority of outstanding Greek bonds via its individual members—and the members must share the losses. For Portugal, Spain, and Italy, this loss sharing will cause financial pain, but they can withstand this with the support of the ECB. Some national central banks might need to be recapitalized, but that can be done within the ECB system. The ECB must make a critical decision on the Emergency Liquidity Assistance (ELA) program. We are seeing a run on the banks in Greece. Through the ELA, the ECB provides banks with cash in exchange for collateral at a discount. What can the ECB do? We think they have three primary options: (1) freeze the ELA and increase the collateral discount, (2) stop the ELA completely, or (3) increase the amount available to sustain the Greek banking system. We believe the first option is the most likely choice. Barclay's research estimates that at the current haircut, the banks have a buffer of €29 billion, and an increase in the haircut will lead to some of the Greek banks running out of cash.

CM: We believe our financial sector portfolio holdings have limited exposure to the Greek banking system, Greek bonds, and the Greek economy. And, thanks to QE and the other ECB programs, we do not expect any disruption to the credit flow to other EZ periphery countries.

Q: Conor, how might geopolitical considerations shape the response by Greek creditors?

CM: If Europe turns off the money flow to Greece, Russian President Vladimir Putin might see a good entry point for Russia to extend its reach. In addition, Greece is Europe's gateway in the Middle East; a more extreme European Union exit (which, by the way, has a legal pathway as opposed to a euro exit) would mean a higher risk of exposure to destabilizing Islamic elements. According to *The Economist*, some 63,000 (mostly Syrian) migrants have arrived in Greece by sea this year, and the EU relies on Greece's cooperation to fingerprint and register as many migrants as possible.

Q: How do you view the risk of political contagion?

AV: The vote against austerity in Greece could endanger the rest of Europe – it increases both the odds of a strengthening of populist movements in other countries and the odds of a Grexit. If policymakers acquiesce to Greece, this may enable populist movements within their own countries. Our base case is that EZ policymakers will hold firm and make few concessions to Greece. They will be walking a very fine line because they would also prefer to preserve the integrity of the EZ and not let Greece leave. But if they have to choose, policymakers will prefer to see Greece go rather than inviting instability within their own countries.

Q: What investment opportunities are you finding in this period of uncertainty in Europe?

CM: One of the most undervalued segments of global markets is European banks. Our international and global value portfolios are currently overweight European banks versus their respective benchmarks. We are interested in seeing the banks engage in restructuring to increase returns on assets and shareholder equity through both improved profitability and a lower capital base. Our preferred banking stocks are, we believe, on the cusp of a significant increase in dividends paid to shareholders, and possibly a return to share buybacks. Most European banks have moved beyond the stage of needing to raise more equity capital; in fact, many banks are generating surplus capital. We expect even a modest uptick in medium-term bond yields in Europe to improve bank net interest margins.

AV: Despite our conservative assumptions about the severity of the US and European bank regulatory environments, several European bank stocks offer, in our view, more than enough upside potential to compensate for their incremental volatility. As a group, at June 30, 2015, European banks traded at less than book value, and at a price-to-forecasted-earnings discount of 30% to the MSCI EAFE Index and 25% to the MSCI World Index. We argue that consolidation of European banks in markets such as the United Kingdom and Spain should herald a gradual rise in profitability concurrent with stability in funding. Most importantly, in a world of low interest rates, the average 4% dividend yield available from many European banks should make a meaningful contribution to total returns.