Fixed Income Special

What outlook for GGBs and impact on peripherals?

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Key points

- This is an updated version of a note published on 3 October here.
- **We continue to see local Greek risk as likely worsening into Q1 2015, on the sizeable threat of early elections and confusion around the Troika's role**. Overall, the performance of GGBs will still remain influenced by global risk appetite for yield, tracking EMBI returns to some extent, though Greece will remain less liquid and more volatile, all the more so with Greece-specific risk on the rise in early 2015.
- **We are more positive on the post-Q1 2015 outlook, assuming that Greek people vote for stability and the current government is returned in any election.** ECB support and the hunt for yield are long-term trends that will continue to support risk. We have been impressed by Greece's capacity to achieve its fiscal targets, though less by the implementation of reforms. If the EA were to play well and as one team, any general election outcome could support stability. But we are more afraid that it won't, as seen lately.

Recommendations

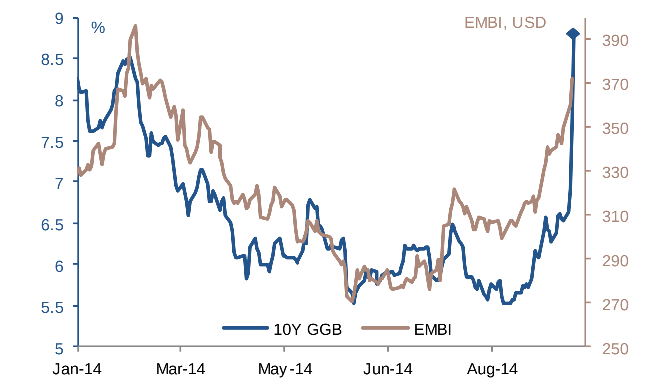
Any elections in Greece would likely lead to the re-emergence of euro area break-up risk. We see this as a potentially large danger for EGB spreads, but mainly in early 2015, now set against the background of overly divergent German-Latin macro policies.

Continue to prefer lower yielding EGBs than GGBs until the election risk is cleared.

Between the Scylla of elections and Charybdis of the Troika

Greece, after two years of relative calm, faces new and decisive challenges in the next few months between a likely general election in Q1 2015 and the completion of the Fifth Review. The latter will help determine Greece's fiscal and financing gaps and set out a new path for debt sustainability.

Graph 1. GGBs overtake EMBI with a vengeance, in 2 days



Source: SG Cross Asset Research, Bloomberg

GGBs have largely followed global sovereign sentiment this year, buffeted by much the same forces that help drive emerging market sovereigns. This is changing: the significant electoral risk is a clear negative for euro-area sovereign carry trades let alone GGBs. Graph 1 shows that GGBs were lagging EMBI. They have now caught up.

We thought over the summer that it would be in the long-term interests of the euro area to support the present government, for fear of the alternative. The Troika could have allowed the current financing programmes to run their course, somewhat like

Ireland and Portugal, allowing Greece to increasingly fund itself in the market. Well, we were mistaken on that. We have seen no evidence of a softer line since September in the Troika negotiations now under way. Some EA officials had been talking earlier in the summer about the replacement of the Troika by less intrusive oversight. Similar surveillance but a less intrusive image would have been more election-friendly for the present Greek administration. But there was no consensus on such a course of action, and it now seems that Brussels has strengthened its resolve to keep Greece on a straight and narrow tack. So the Troika has been adopting quite a tough line in the present negotiations to complete the Fifth Review, e.g. in refusing to sanction cuts in taxes or allow any let up in the process of reform.

There thus seems to be little forward thinking in some European capitals about navigating around the Scylla of elections and the Charybdis of the Fifth Review in the months to come. The current sell-off in Greece in part reflects the lost opportunity of supporting the present administration, ahead of likely early elections. The ongoing deterioration of growth prospects in Europe and the policy divergences have helped amplify the market reaction.

Greek political risk ever higher into 2015

The challenge in early 2015 is this: by February, the Greek parliament must elect a new national president. It is an honorary position; however, the Greek constitution requires that up to two thirds of parliament must agree on a candidate otherwise parliamentary elections are mandatory.

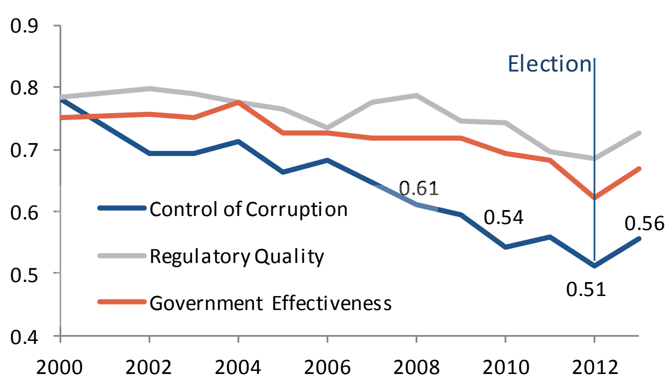
Suspense is guaranteed before the parliament is automatically dissolved, with the constitution requiring three ballots spread over a 10-day period to see if a two-thirds majority can be found. ➔ Such a constitution seems tailor-made to heighten market tensions, all the more so as the current government barely has 50% support in parliament and the opposition is gunning for early elections.

The return of the far-left opposition Syriza as the largest party in parliament, maybe even with an overall majority, is largely supported by the opinion polls. We wouldn't however be entirely glum; Greece was faced with a similar challenge over two years ago and stability-minded voters helped overcame it.

Also the opinion polls are more nuanced once we dig into the detail; for example, they tend to find large support among the Greek electorate for remaining in the euro, in sharp contrast to the headline support for the euro-sceptic Syriza. We had a similar dichotomy in the polls ahead of the last elections, and in the end investors voted for stability.

The present government has a track record of achievement in some areas; that can be bolstered by the EA authorities, though **we have yet to see evidence that common electoral interests are impacting the present Fifth Review negotiations.**

Graph 2. Political indicators improving since 2012 election



Greece institutional rank 2000-2013, composite indices. Higher rankings correspond to better governance. Source: World Bank, SG Cross Asset Research/Rates

So this electoral risk is very likely to become an ever more threatening cloud over GGBs in early 2015. At the least early elections carry the risk that the reform programme is subject to more delays; the programme could even be thrown in the dustbin should the post-electoral landscape ever turn into a minefield.

How will Greece overcome its financing needs hump?

Greece has more than met many of its fiscal targets over the past two years, in contrast to those for reforms. So its fiscal performance ought to be a good news story, though it is often portrayed in negative terms.

Greece has several funding gaps that are grabbing media attention but are often jumbled up. Greece has been outperforming its fiscal targets but, for a number of what we might call technical reasons, there is a shortfall of €12bn in the financing needed for the 2015 redemptions[1]. There is also a likely fiscal gap in the execution of the 2015 budget, though likely modest in size (€0.9-€2bn).

Table 1. Compliance with targets has been strong since 2012

	Fiscal Balance		Primary Balance	
	Target	Realised	Target	Realised
2010	-8	-10.4	-2.4	-4.9
2011	-7.6	-9.4	-1	-2.3
2012	-6.3	-6.3	**-1.5**	**-1.3**
2013	**-4.1**	**-3.2**	**0**	**0.8**
2014	*-2.9*		*1.5*	
2015	*-2.1*		*3.0*	

Well-met targets highlighted in blue bold.
Source: IMF, EC, Moody's. Data from First Adjustment Programme, 2010; 2nd Adjustment Programme, 3rd and 4th Reviews of EC

Yields are too high to countenance market issuance. At rates as high as 7.5% for 2017 paper, issuance at such a high coupon would clearly undermine Greece's profile of debt sustainability.

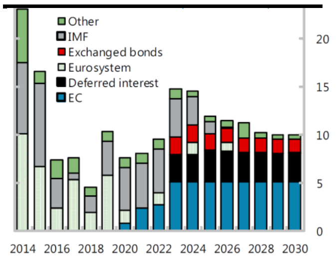
➔ That said, we see Greece as having enough alternatives to fund the various funding holes without necessarily resorting to a new programme, though it would require some unpalatable accounting and rely in part on bank support. The Troika has showed marked reluctance to facilitate such actions.

Greece needs some extra €12bn in financing for 2015. That need does not stem from the budget deficit; Greece rather has been outperforming its fiscal targets. Financing needs are now dominated by amortisation. They arise in large part from the €12bn cash spent upfront in the December 2012 buyback of GGBs, a few months after the second programme was agreed. The buyback was an idea proposed by the Bundesfinanzministerium in October 2012 (a great one from the taxpayer perspective with the benefit of hindsight). The operation was not envisaged in the earlier programme and was financed in December 2012 with a 6-month EFSF bill.

The Eurogroup validated the buyback. At the time, some EU officials suggested funding part of the €11bn with a rollover by Eurosystem of Greek bonds held by the ESCB. This so far has failed to materialise, with some central banks arguing this would be against their Treaty obligations.

The 2012 buyback operation has since funged with the general budget, thereby clouding the history of the gap (other factors have also contributed to the funding gap e.g. central banks have been refusing to roll over some GGBs they held, as was seemingly agreed previously).

Graph 3. Amortisations low in 2016-20, €bn



Source: IMF, SG Cross Asset Research

Originally, the IMF and EA programmes of assistance were due to end at the same time in 2016. But given the operations on the capital side of Greece's balance sheet, the EC cash is running out much sooner (December of this year for the EC, Q1 2016 for the IMF). **So the issue arises as to what will replace the EA cash – more official support,**

[1] As mentioned in Troika or rating Agency reports, e.g. table 14, p56 of IMF's 5th review http://www.imf.org/external/pubs/ft/scr/2014/cr14151.pdf

or resources that Greece finds itself? The solutions could range from a third formal programme with more official loans, to looser arrangements with revised terms and alternative sources of financing.

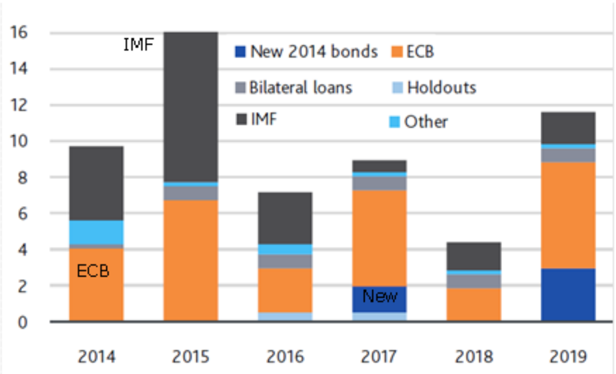
In addition to the above, there is some uncertainty around how the 2015 budget will be covered. The Greek authorities seem to suggest that the remaining gap – a mere €0.9bn for them – can be met by stronger growth next year. The IMF sees the hole at €2bn and is calling for specific measures.

The funding problem is unique and acute in 2014/2015. Gross borrowing needs are some 20% of GDP in 2014, dominated by IMF and ECB repayments; other official sector repayments, like the EFSF, only come much later. So far, the EFSF and IMF have distributed some €225bn to Greece since 2010. The last operations will largely complete the process of transferring Greek debt into foreign public hands i.e. over 90% is held in by public creditors.

There is an additional, much smaller, amount required to finance the 2015 budget deficit (€0.9bn says the Greek Ministry of Finance, €2bn according to the IMF)[2]. The sum – maybe €14bn - can likely be met in several ways, without recourse to tapping into a new programme of official loans.

Greece continues to insist it will issue a 7-year bond[3]. But if there is no funding yield that makes Greek debt sustainable, what are the other options to fund the gap in 2015? Apart from better than anticipated growth (as seen in Ireland and Portugal), the other options essentially involve either 1/ internal resources (e.g. unused funds in government agencies) or 2) further repayments from local banks (and despite the upcoming AQR and the ECB's misgivings). **Some €11bn earmarked for bank recapitalisation remains unused.** The amount available will obviously shrink if one or more local banks seeks capital from the HFSF (Hellenic Financial Stability Fund) after the ECB's AQR and stress tests conducted by EBA. But it could remain stable if other measures support domestic banks (in other countries, tax credits have performed such a role). The HFSF buffer is meant to expire this year, unless the Eurogroup and other parliaments were to approve an extension.

Graph 4. Official creditor amortisation now dominates, €bn



Source: SG, Moody's, IMF, PDMA

However, with cash fungible and assets hard to value, the fear of the ECB is that it could be treated as a cheap piggy bank. New opportunities beckon with the TLTROs. Over the summer, the ECB was adopting a tougher line, with the ECB's Mr Coeuré saying that Greek bank access to the TLTRO could be "constrained". Collateral offered by Greek banks to obtain access to ECB liquidity programmes has been seen by the ECB as inadequate.

The Greek press has long affirmed[4] that Greek banks can continue to use Greek bonds as collateral for TLTRO funding from the ECB. We are not quite sure of the status now, but we have **confirmation by the ECB of a report on the 16 October that haircuts on Greek paper would be relaxed**. The same report suggested that access by Greek banks to ECB cash could be

[2] There are a number of uncertainties e.g. greater expenses given a constitutional court decision retroactively cancelling wage cuts for some uniformed personnel

[3] Market News, 16 October {NSN NDJHQD3H65TS <go>}

[4] {NSN NARQ4F6S972B <go>}

made conditional on broader progress by Greece in implementing reforms. The ECB's Coeuré has also said in public that it is up the EU Council and Commission to decide what the outlook is for the Troika and the prescriptions of reform. So at this stage, we need to wait and see what will be the outcome of the talks currently underway, along with the Greek bank stress tests.

In a nutshell, Greece's objective over the past two years has largely been to seek additional debt relief while buying time on the domestic front for matters to stabilise; in contrast, Europe and the IMF have wanted to create conditions in which Greece could stick to its amortisation programme, while implementing reforms to spur longer-term growth. Indeed, Greek compliance with fiscal targets - if not reforms - has been strong since 2012 (Table 1).

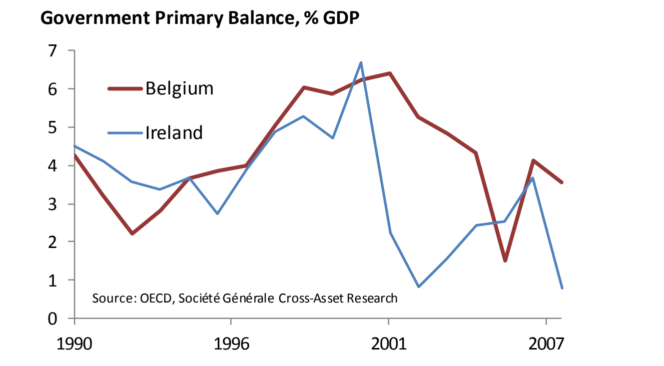
The cat and mouse game between the Troika and Greece is now in a new phase, driven by three new developments: two we have seen above: 1) the upcoming expiration of the present three-year programme, culminating in the "Fifth Review"; 2) the same €12bn gap for 2015; and 3) the risk of a general election in H1 2015.

Beyond 2016, Greece is seen as running huge primary surpluses

Beyond 2016, Greece's gross financing needs should decline rapidly, given the now very long maturity profile and projected rise in primary surpluses (though to unrealistically high levels in our view). So current Troika plans see gross financing needs at only about 6% of GDP by 2022.

It is true that the public deficit figures are promising. The January-June 2014 deficit was €2.4bn compared to €5bn over the same period in 2013. Revenues were €1bn higher in H1 2014, though arguably this is due to higher EU funds inflows, bolstering Greece's public investment budget by €1.2bn more in H1 2014 over H1 2013. The cumulated government deficit was just 1.6% GDP, and the primary balance saw a surplus of 1.6% GDP (the Greek MoF has since assured us that the 1.5% target for this year will be significantly exceeded).

Graph 5. Even in good times, very hard to run a 4% primary surplus. Troika expectations are unreasonable.



Source: SG Cross Asset Research/Rates

Still, we would be worried about extrapolating such trends. And yet the targets suggest an extraordinary level of primary surpluses after 2015. The government primary surplus in programme terms is set at a minimum €2.75bn (1.5% GDP) in 2014 rising to €5.7bn (3% GDP) next year and an extraordinary €8.9bn (4.5% GDP) in 2016. These numbers imply an overall government deficit of 2.9% GDP in 2014, 2.1% in 2015 and a mere 0.7% in 2016. **The IMF's debt sustainability exercise supposes thereafter mostly 4% GDP primary surpluses over many years;** this will eventually cut debt to a "sustainable" 110% of GDP.

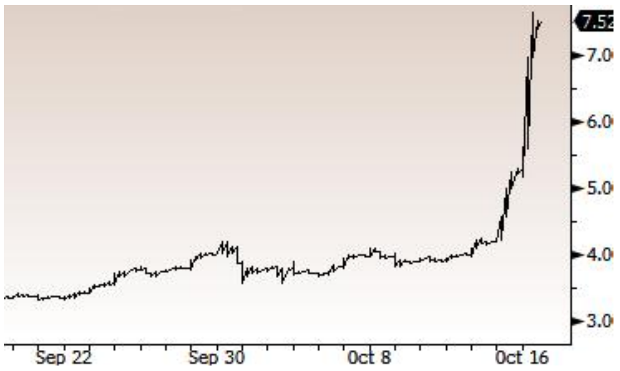
The extent of this challenge can be judged from past sovereign performance. Graph 5 shows that during the "booming" 1990s, Ireland and Belgium only occasionally had primary surpluses above 4.5%. This suggests that the primary surplus targets set by the present Troika programme are demanding in the current political and social climate.

Primary surpluses in the 2-3% area over the subsequent years would be a much more reasonable hypothesis, given the performance of other countries (Italy in particular). But for this to be feasible, and for no additional emergency assistance to become necessary, both solid reforms need implementation and some loans can be extended at low rates. Both topics go the heart of current Troika-Greece discussions of course.

Market access not a viable long-term option for Greece in size

Greece is now said to be planning a 7-year issue[5] or reopening the current 3s and/or 5s, or even preparing an exchange[6]. But why would Greece want to fund itself at all in the market, if more attractive funding can be obtained from the ESM, and given doubts whether market funding – even at 4% previously - is sustainable in the longer term?

Graph 6. Even at 4%, the GGB 3.375% 2017 yield was still too high to make Greek debt sustainable, yield %



Source: Bloomberg, SG Cross Asset Research

In a secularly stagnant Europe, we fear, market rates – even at 4% on the 5-year over the summer - are just too high to make Greece's debt profile sustainable, even given the much better terms this year.

Greece should be running a primary surplus over the coming years, meaning that it is essentially funding redemptions through new bond issues. Some of the financing will have come with particularly low rates of 2% or less (in particular short-dated or bank paper, and some of that funded through the ESM/EFSF). It would have been indeed ironic if the refinancing cost was going up and not down through other sources of borrowing.

That said, market funding had facilitated the interests of the Greek government. In the first instance, it gave the Greece authorities confidence that they could get over the 2015 financing hump on their own terms. The market funding is also making it easier to slow the required run-up in the primary surplus. Third, access to the market gave the Greek authorities some leverage with the Troika, but the context now is changing.

Two rating reviews of the Hellenic Republic due before year-end

Fitch, 21 November, already upgraded over the summer to 'B'; outlook stable. Also, in July Fitch upgraded five Greek covered bond programmes to between B+ and BB-, rated on a recovery basis only; outlook stable for all programmes (after upgrading 15 tranches of RMBS). Among the factors that could lead to another upgrade of the sovereign, Fitch sees "A successful programme exit, with market access at affordable rates and debt relief on official loans (OSI) on terms that significantly improve long-term public debt dynamics." **We don't see that condition being realised by November to quite justify another upgrade.**

Moody's, 28 November, already upgraded last month to only Caa1 from Caa3, outlook stable (still two notches below Fitch). Moody's upgraded the ratings of four Greek covered bond programmes in July, to between B1 and Ba3 (with Eurobank CB II unchanged at B3). Moody's says it could consider upgrading the Hellenic Republic again in the event of (1) an increase in the pace of fiscal consolidation, and structural reforms; (2) ongoing economic

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growth and (3) more certainty and visibility on future external financial support and the politics. **Like for Fitch, we do not see these (vague) metrics quite justifying another upgrade by November. Afterwards, any election and subsequent policy choices are obviously key.**

S&P. On 12 September, Greece was upgraded to B with a "Stable Outlook" from B- (set in December 2012, so almost two years ago, and just after the December 2012 buyback). Now the S&P rating is the same as Fitch's and two notches above Moody's, and S&P has a similar analysis to the other agencies. S&P had calculated the Greek market implied rating from CDS – even at the very low rates of September - as only B- (CDS barely trade though).

Conclusions: long-term challenge greater than the short-term one

The overarching challenge is to ensure that Greece sees better growth and inflation to allow it to repay its debts. That will play out over years or even decades, though will be helped along if Greece can negotiate longer terms and lower official rates for its funding. Market rates, even at the very low levels over the summer, make this task hard. A similar dilemma is faced by many Western governments, if on a less severe scale (as the recent Geneva – ICMB – CEPR study[7] on deleveraging reminded us).

The current saga can drag on till past any early elections. There is no imperative to come up with a deal now, given that Greece remains fully funded into April 2015 at least. Greece's prime interest is in negotiating more favourable long-term financing and less intrusive oversight. So it might well want to hang on for a better deal over year-end.

Any elections in Greece would likely lead to the re-emergence of euro area break-up risk, we fear. In contrast to much research and talk we have seen over the past few years, we see an evolution of institutional arrangements between Greece and the euro area as eminently possible. Cyprus pointed the way towards what could happen. Even messier outcomes are possible; they would not be rationally planned, but politics can drag us down to places no one would want to go to with the benefit of hindsight. **We see this as a potentially large danger for EGB spreads, but more so in early 2015.**

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[7] http://www.voxeu.org/sites/default/files/image/FromMay2014/Geneva16.pdf

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