current PERSPECTIVES

Greek Update

In spite of intense negotiations between highly indebted Greece and its euro-zone creditors, a resolution to Greece's credit woes remains elusive. Currently, Greece insists it can't pay its bills without funding and debt relief, and the euro zone insists it can't provide funding (by extending more credit) unless Greece agrees to act on three key issues: budget surplus targets, pension reform and labour market reform. Faced with this stalemate, the Greek Prime Minister announced that he would put the euro zone's latest proposal to a referendum vote on July 5. With a resolution being delayed until after July 5 and a large debt payment due to the International Monetary Fund (IMF) on June 30, it seems a virtual certainty that Greece will fall into arrears.

Following the announcement of the referendum, the European Commission urged Greece to stay in the union and provided Greek voters with a synopsis of its bailout proposal. Meanwhile, euro-zone officials announced that they would not extend Greece's bailout beyond June 30 and the European Central Bank (ECB) indicated that it would not be providing additional assistance to Greek commercial banks. As a result, Greece has imposed capital controls and closed its stock exchange and banks until after the referendum.

Our View

The risk of Greece exiting the euro zone has increased meaningfully. While the July 5 vote is ostensibly about the current bailout proposal, really the Greek people are being asked whether or not they wish to remain in the union. While a failure to pay its loans and an exit from the euro zone would be unsettling, it's important to keep in mind that Greece is a very small component of the euro zone, contributing less than 3% to the region's GDP, and TD Asset Management ("we") views its potential exit as manageable. The majority of Greek sovereign debt is held by bodies such as the IMF and ECB rather than private sector creditors, and we believe that Greece's creditors have the capacity to absorb associated losses. In addition, under its current quantitative easing program, the ECB has the ability to purchase the bonds of other peripheral countries, such as Portugal and Spain, which should help to prevent panic and support asset prices.

Therefore, in the short term, we believe that while the situation in Greece will lead to some market volatility, it is unlikely to cause a financial crisis or severe market decline. However, there are two other important points to be considered. First, as we have been highlighting all year, our expectations for 2015 are for modest returns with increased volatility. The current trigger for volatility is Greece, but the broad underlying conditions for investors are low economic growth, low fixed income yields, decelerating earnings growth and stocks near fair value. In this sense, the challenge in Greece is just one headwind among many. Second, in the long term, the euro zone will need to grapple with the underlying economic conditions that arise from the fact that its members may pursue different fiscal policies and operate at different levels of economic productivity. This could create prolonged tensions and intermittent volatility.

Portfolio Positioning

We have been cautioning about the potential for increased volatility for some time, and this was one of the contributing factors in our decision to scale back our equity overweight to a more neutral position during the first quarter of the year. We continue to believe that investors should take a long-term view of their investments and that they can be well served by a diversified portfolio consisting of a mix of high quality Canadian and global stocks with the ability to grow their dividends and high quality investment grade bonds. Exposure to global equities provides diversification, in part through exposure to currencies such as the U.S. dollar, which may rally during periods of volatility, and bonds can play an important role in providing stability to portfolios during times of market volatility.

We continue to monitor and evaluate this situation and to assess conditions with the objectives and best interests of our clients in mind.■

Bruce Cooper, CFA

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