BERMAN CAPITAL ADVISORS

June 30, 2015

The Greek Endgame

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Summary

Global markets are in turmoil today as the long-running Greek financial crisis is finally coming to a head. Despite the recent turmoil, for investors the negative impact of this seemingly never-ending crisis will likely be limited. Crucially, and unlike the 2011 crisis, Europe has likely done enough to prevent a broader financial contagion if there is a default. Contagion has always been the real issue, as Greece itself is a tiny part of the global economy.

What Happened?

In January, Greeks elected SYRIZA, a leftist government that claimed to be able to renegotiate the terms of Greece's recent international bailout. Bailout austerity has been very unpopular because it has further depressed the Greek economy (the issue of Greece's previous profligacy aside). Ever since, the Greek and Eurozone creditors have been playing a game of chicken. Greece says it cannot endure any further cuts, while its creditors have refused to extend the bailout without a deeper commitment to austerity and labor reform. Just last week an agreement appeared in sight, but after the events of this weekend hopes are fading fast.

As it turns out, the Greek government had less negotiating leverage than it had hoped, and its aggressive negotiating tactics have infuriated other European governments. Last Friday, the Greek government announced it would hold a public referendum on the "last, best" offer the Eurozone negotiators offered on June 25. By Sunday, an accelerating bank run prompted the government to announce it would close the banks and stock market until after the referendum, thus capital controls, a desperate measure, are now in place. At the moment it is difficult to say how the referendum will turn out. In the meantime, Greece faces a large, $1.7 billion payment to the IMF it will almost certainly miss.

A negotiated solution remains possible, but will likely turn on the referendum. It seems very unlikely that Germany and the other Eurozone members will cave due to the terrible precedent it would set, and because it would be highly unpopular with domestic voters. If there is a pro-bailout vote, then the SYRIZA government will likely resign and further negotiations will occur.

Impact on Investors

If, as seems increasingly likely, Greece defaults and exits the Eurozone, the implications for the world economy are likely to be modest. Removing the perpetual uncertainty might even be a long-term positive. Fundamentally, the currency bloc should be stronger as the remaining members are in better economic shape. A Greek exit would also provide clear lessons for irresponsible borrowers and lenders.

The equity market reaction yesterday, while notable, is well below the levels of a full blown crisis. More importantly, the prices of other peripheral European sovereign bonds are not cratering. Spanish ten-year government bond yields, for example, are higher than a month ago, but at 2.3% are a third of their 2012 highs. So initial signs of contagion are quite low, even without overt intervention from the ECB or European financial stabilization funds, which would surely follow greater signs of disquiet. Markets have had plenty of time to adjust to the possibility of a Greek exit from the Eurozone.

The connections between Greece and the rest Europe, let alone the global economy, are even smaller now than they were in 2012, when Greece last came close to an exit. The bulk of Greece's public debt is now held by "official" (non-private) creditors, who could bear losses without channeling further contagion. The exposure of European banks to Greece has been reduced to just $50bn at the end of 2014.

Recall that Greece's population (11 million) and economy are both quite small. Greece's share of world GDP has fallen to a negligible 0.3%. Exports to Greece from the major advanced economies are miniscule. Apart from neighboring countries such as Bulgaria and Yugoslavia, emerging economies' exposure to Greece is also tiny.

Events are still unfolding, thus investors should take a prudent stance. But if European equity prices continue to decline, the crisis may represent a buying opportunity for investors seeking international exposure.

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