

PRESS RELEASE

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HERMES CHIEF ECONOMIST: THE THREE EXITS

In his Q3 Economic outlook, Neil Williams, Group Chief Economist at Hermes Investment Management, identifies the three exit risks currently for financial markets: Greece; the US Fed's own type of 'exit' - from ultra-loose policy; and the threat of 'Brexit'.

The situation is fluid. But, while our base case has been Greece remains in the euro - partly because of the pitfalls of exit and incentive of QE - a long-term debt restructuring now looks inevitable and desirable.

Done well, it could allow Greece to lock into current low funding costs. It would reduce uncertainty, and put the onus on meeting its primary-surplus targets more via growth than austerity.

After a 22% loss of real GDP and deep fiscal consolidation, this could reduce 'reform fatigue'. As my chart below reminds us, the *quid pro quo* for Greece in getting inflation down in the euro has been lost GDP and jobs.

But, with Greece's 'knife-edge' referendum offering no better than an impasse or fresh elections, an early agreement looks unlikely.

Coping with the strains outside the euro would be even harder for Greece in the short term.

Inside the euro, with a new IMF programme, Greece would in time qualify for ECB QE. This would provide monetary relief to its fiscal consolidation, and give chance to access market funding.

Delay though may come from the necessary passage through euro-zone parliaments for Greece to first borrow from the ESM so the ECB can redeem its Greece bonds. This plus an aversion to moral hazard, as Portugal and other 'bail-out' countries stand watching, suggest QE by September would be a best-case outcome.

Although events are fast moving, logic suggests Syriza will want to avoid the harsher pitfalls of exiting the euro and possibly even the EU.

Outside the system, the excessively high market interest rates that would be needed to prove the creditworthiness of the new, substantially weaker drachma would risk stagflation, and escalate funding costs on what would then be 'foreign-currency' (euro) debt. This would be not be supported by Greece's former euro peers.

Avoiding this scenario, though, needs restructuring, and reform.

Contagion would be more likely to flow from leaving the 'exit door' open

With only one fifth of Greece's debt held privately (the rest by official institutions), and banks elsewhere in relatively better shape, contagion would be more likely to flow from leaving the 'exit door' open, than a direct financial hit from a Greece default.

Most vulnerable are the Greek banks exposed to deposit outflows and the inability to use their Greek government bonds as collateral. Capital controls may therefore not be lifted till the ECB unlocks its Emergency Liquidity Assistance.

For financial markets, QE for Greece in late summer (best case) would be well timed, given the US Fed's own type of 'exit' - from ultra-loose policy. This starts with its first rate hike since 2006, probably around its new economic forecast in September or December.

Beyond that, the EU referendum by the end of 2017 – the third ‘exit risk’ - will be the big ‘known unknown’ for UK assets. Logic suggests the unlikelihood of the UK wanting to weaken ties with its main trading partner. Dealing with a ‘Brexit’ (only our risk case) may need to reactivate QE - if growth is expected to be hit and international investors in gilts (which account for about one third of the £1.3trn gilts outstanding) are put off by a weaker pound.

Elsewhere in the G10, meanwhile, the monetary reins are loosening. The ECB has drawn a ‘line in the sand’, by pledging to buy sovereign debt down to a -0.2% yield. This gives the bond vigilantes something to aim at, and will prolong the search for yield.

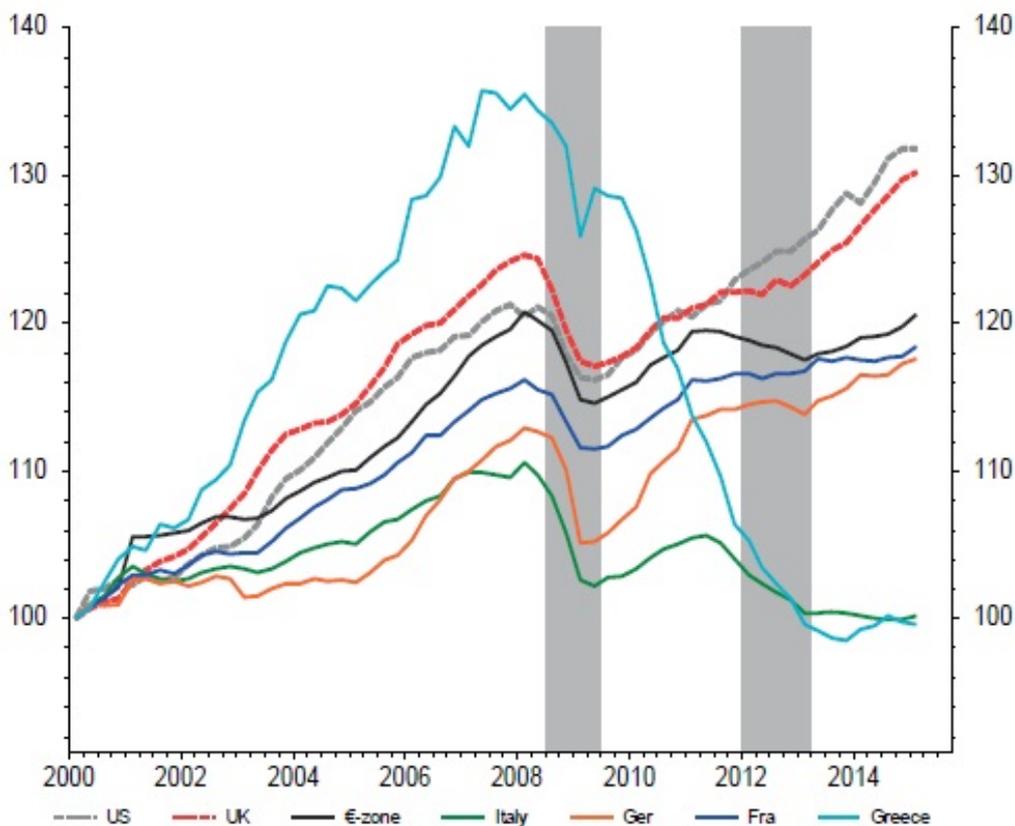
Then there’s Japan, which, in its third year of Abenomics, is again losing inflation momentum. And, those competing, such as China, will likewise resist currency appreciation. Even strong-growth Australia and New Zealand are cutting rates.

Which all reinforce our view that 2016 will be no ‘1994’, when the Fed’s rate hikes hit most assets hard. Then, the Fed was worried about ‘overheating’ rather than normalisation; now, central banks have too much ‘skin in the game’ to take us off guard.

Meanwhile, however, the glue holding EMU together needs to remain intact.

Chart ...But, Greece (& Italy’s) GDP is, net, no higher with the euro

Real GDP levels, re-based to Q1 2000 (=100). Grey denotes euro-zone recession



Source: Thomson Reuters Datastream, based on national data

Read the Q3 *Economic outlook* from Hermes Investment Management.

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Notes to Editors

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