Morgan Stanley

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Economics & Strategy Insights

# Greece: In for the Long Haul

- **Economics: The political situation may well get worse before it gets better. Yet, while risks remain substantial, we think uncertainty around the bailout 'exit' may get resolved soon, and the economy is likely to start growing.**

- **Sovereign Credit Strategy: Given the improved risk/reward following the recent sell-off, we return to a constructive stance in the Greek fixed income complex. While volatility in the coming months is likely to stay high, current valuations provide adequate protection, in our view. We recommend long positions in the GGB strip and favour bonds to GDP warrants.**

- **Equities: While political uncertainty is likely to remain a significant headwind, our EEMEA Equity strategists are OW Greece, given it is oversold, offers long-term recovery potential and may benefit from improved sentiment on EU banks following the AQR. Our Banks analysts retain their positive longer-term view on Greek banks, yet believe macro and political risk factors need to subside before stock performance reflects the improving fundamentals.**

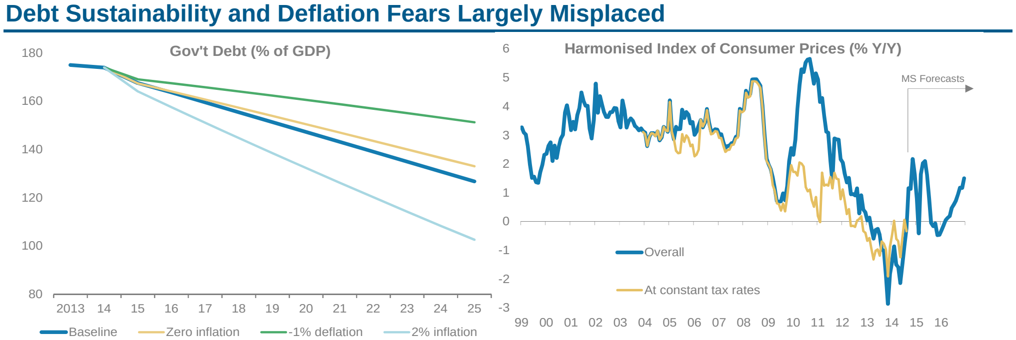
## Economics *(Daniele Antonucci)*

**Uncertain near term, constructive medium term:** Our cautious stance on Greece's economic, policy and political situation seems to have played out (see our *Back to School* report, September 7, 2014). We think that politics is unlikely to become less uncertain over the next 4-5 months. Yet the policy discussion around an earlier bailout 'exit' is likely to settle relatively soon, in our view, with a likely compromise having a good chance to come through, and the economy seems close to stabilisation. In this note, we look at Greece's near-term risks and review our positive medium-term view, which we believe remains in place.

**The Greek trigger…** The recent bout of market volatility, according to some, appears to have started with concerns around Greece's situation along three key aspects: 1. the uncertainty around the presidential election next February, and risks that this may trigger an early political election together with less market-friendly policy actions; 2. prospects of Greece leaving its bailout programme sooner than expected without a clear backstop and a way to close its funding gap; and 3. a weaker-than-envisaged recovery.

**…and *debt*flation fears:** All this has been compounded by concerns around debt sustainability, especially given that Greece *already* is in deflation, and its economy keeps shrinking. Yet deflation has to do with Greece's economic rebalancing and reforms, which may have made prices more responsive to downward pressures. So, a downward adjustment in prices is not only expected, but also welcome as competitiveness is recovered and consumers and firms get some respite (see *Deflation – Friend or Foe?* February 3, 2014).

**Debt Sustainability and Deflation Fears Largely Misplaced**




Source: Eurostat, Morgan Stanley Research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**Missing the point?** Should deflation last for a long time, the concern is that the cost may well outweigh the benefit, i.e., as nominal incomes continue to shrink, the debt-deflation spiral becomes self-fulfilling. Yet the standard debt-sustainability framework appears rather inappropriate to look at Greece's situation, in our view. This is because the 'debt equitisation' that's happening in this specific case, as policy-makers continue to lengthen the maturities of the official loans and reduce interest rates, is the dominant force at play that keeps the debt *trajectory* on a downward trend even in case of sustained deflation (see [Debt*flation: One Shock Away?*] September 22, 2014).

**Thinking through the endgame:** In fact, 'debt equitisation', of which we expect another round possibly in 1H15 as part of the negotiations with the European policy-makers, is such that the debt *level* too improves way beyond what appears when one simply looks at the debt/GDP ratios. Think about this: if I owe you a million euros, but in 50 years and at an interest rate of 0.1%, I surely have a debt, but in reality I'm getting equity for half a century. This is the endgame, at least for quite some time: Greece's official loans (not the GGBs traded in the market) are becoming more and more some sort of semi-perpetual debt.

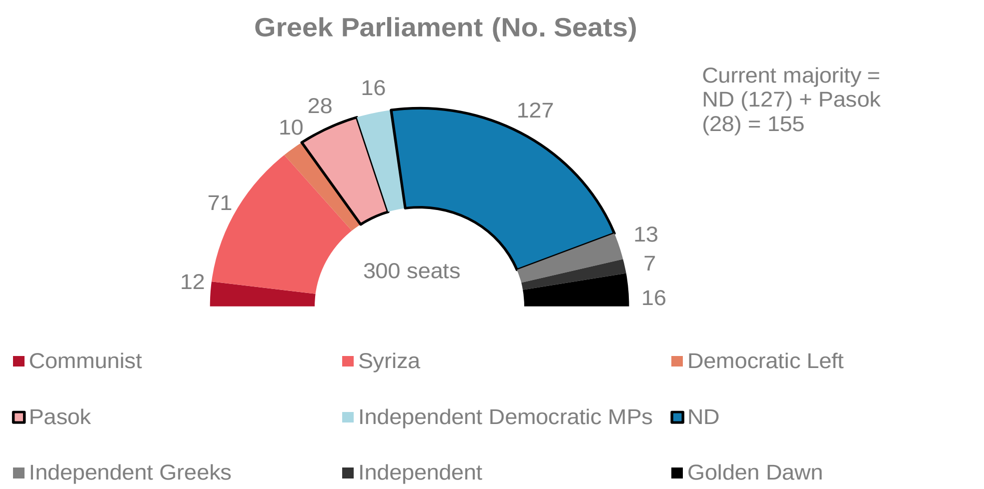
**Where to from here:** Below we look at how the three market concerns we highlighted before (politics, policy and the economy) are likely to evolve, taking a 12-month view:

**1. Politics – what's going on with the presidential election:** Far-left Syriza has declared that it would oppose any candidate put forward by the government to take over from President Karolos Papoulias when his second five-year term expires in early February 2015 (see here). Given that the government cannot count on the backing of the Communist Party, if Syriza and Independent Greeks were to vote against any candidate, he or she would not receive the three-fifths majority (200) seats needed in the first two rounds of voting and would struggle to get the 180 votes required in the third and final ballot. Failure to elect a new President would trigger early parliamentary elections.

**Unlikely to get better any time soon:** The political situation remains quite fragile, and it's inter-linked with the state of the economy, especially the very weak labour market. At this juncture, there's considerable uncertainty on whether the presidential election may result in a stalemate, leading to national elections further down the road – with potential implications for the timing of urgently needed structural reforms. There is no way to predict how this will go at this stage, and the recent confidence vote won by the government seems less relevant to get a sense of what will happen. This is because it only needed a simple majority (which the government can count on, albeit razor-thin), and also because the political incentive is probably to commit to the presidential election at the last moment.

**Extra official relief?** So things may well get more uncertain from this perspective, and there's a risk that a different government may put in place quite different policies than those that market participants have seen so far, i.e., broad compliance with the bailout programme (or at least attempts to comply with it). Yet, regardless of the outcome of the election(s), the chances are that negotiations with the Troika may well lead to interest rate charged on the European portion of the official loans getting reduced to near-zero and the maturities being extended further. While this is widely expected in the marketplace, it may well be that it's sufficient to find a compromise among the domestic politicians, especially if accompanied by less austerity.

**Uncertain Political Situation Ahead of the Presidential Election**



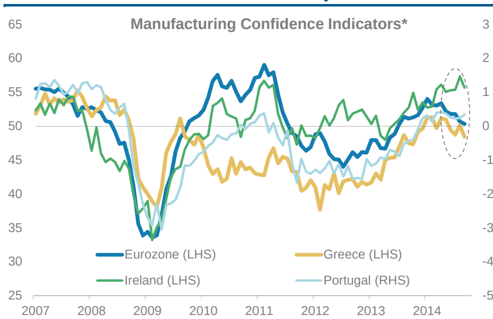

Source: Greek Parliament, Morgan Stanley Research

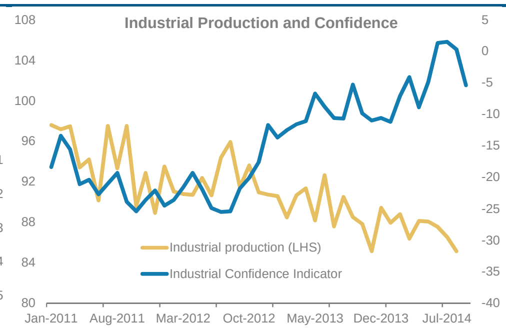
**2. Policy – early bailout exit unlikely…** One market worry is that Greece may find itself without a credible backstop and with a sizable funding gap, if it were to leave the bailout programme at the end of this year, thus foregoing the IMF funding scheduled for 2015-16. Next year alone, this would mean finding some €7bn, perhaps by issuing debt. Because of the recent market volatility, this may now be called into question. We think that there's room to find a compromise in this area too, with Greece not going through a third full bailout, but perhaps just a precautionary credit line (and thus some form of monitoring).

**…but third *full* programme not forthcoming either:** Yet domestic appetite for extra bailout funds in exchange of full macroeconomic surveillance seems quite low, we think. And a credit line doesn't solve the problem of the funding gap anyway. So Greece may perhaps be allowed to use the residual money in the Hellenic Financial Stability Fund (which is earmarked for bank recapitalisation) to close the funding gap along with some of its cash reserves. At the same time, a carefully designed credit line would provide the conditions for ECB support in the context of the new ABS and covered bond purchase programmes.

**3. Economy – the dataflow continues to be mixed:** Industrial production has fallen back again in negative territory. And, although some consumer-related indicators are getting better, i.e., retail sales are on a recovery path, and tourism continues to be strong, most forward-looking surveys have weakened recently. The key manufacturing PMI, at 48.4, posted its lowest reading in almost a year in September, as output and new order intakes fell simultaneously. The 3Q picture for the sector as a whole is therefore one of broad stagnation. The European Commission sentiment indicators, having depicted a more positive picture previously, are now deteriorating too.

### Near-Term Economic Underperformance



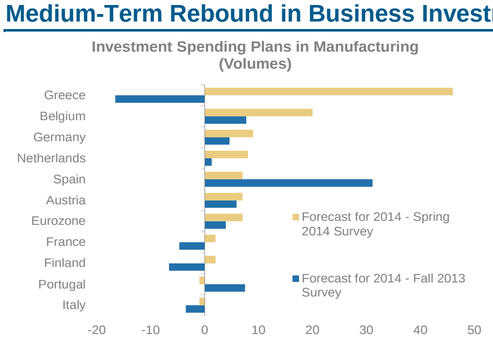



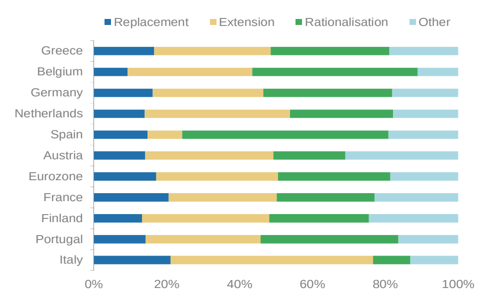

*European Commission Industrial Confidence Indicator for Portugal as no manufacturing PMI is available.
Source: Eurostat, Markit, Morgan Stanley Research

**Business cycle – starting to grow from here:** Our forecast of an expansion of 1.3%Y in 2015 after zero-ish growth this year rests on the assumption of easier monetary and fiscal conditions, which may well support business investment. However, base effects play a key role too, i.e., the economy has contracted so much that even a quasi-stagnation is likely to result in positive *year-on-year* growth. Yet 2016 is likely to mark the first year of almost self-sustained growth, in our view, where *sequential* growth too strengthens visibly.

**Consensus forecast – now more realistic:** The median forecast of private sector forecasters has fallen somewhat, and is now roughly in line with ours. Yet we remain about 160bp below the Troika forecast for 2015. This is not to say that we don't believe that the economic path has nearly troughed. We do. Yet the key question for investors is whether Greece can achieve sustained growth. We think it can, but it's likely to take longer than expected, which is one reason why market participants have been disappointed on the near-term outlook lately.

### Medium-Term Rebound in Business Investment?




Note: Note: Spring Survey – Question: State % change in investment this year on investment last year; Fall Survey – Question: State % change in investment next year on investment this year.
Source: European Commission, Morgan Stanley Research

## Sovereign Credit Strategy *(Robert Tancsa, Paolo Batori)*

**Near-term uncertainties not new…** Investors have already been aware of the main near-term challenges related to politics and a potential funding gap. Indeed, we moderated our view on GGBs in our Fall Outlook, citing a more balanced risk/reward and potential for increased volatility around these risk factors (see *Global Strategy Outlook: Investing in an Out-of-Sync World*, September 7, 2014).

**…and unlikely to go away soon:** As our economist explains, these uncertainties are likely to linger, and potentially even deteriorate, until early next year. Political uncertainty related to the presidential elections will keep volatility high and questions around the funding gap will also require several important political decisions. We think the nearly €9bn funding gap in 2015 could be filled with a combination of i) tapping the unused bank recapitalisation funds, ii) cash deposit drawdown, and iii) market financing.

### Nearly €9bn Funding Gap in 2015

| Funding needs | EUR mm | Funding sources | EUR mm |
|---|---|---|---|
| Budget deficit (incl. interest payments) | 2,000 | Privatisation | 2,200 |
| Arrears | 2,500 | ANFA & SMP | 2,000 |
| Medium- and long-term debt redemptions | 15,622 | IMF | 7,100 |
| Market debt (holdouts) | 362 | **Total funding sources** | **11,300** |
| ECB bonds | 6,680 | | |
| IMF loans | 8,580 | | |
| Other loans | 0 | | |
| **Gross financing needs** | **20,122** | **Funding gap** | **8,822** |

Source: IMF, Bloomberg, Morgan Stanley Research estimates

**Long-term outlook still attractive:** However, the long-term potential of Greece is still intact, as pointed out by our economist. Ultimately, Greece represents European risk and with its 'twin surplus' and growth picking up, convergence both from a fundamental and market perspective should take hold.

**Valuations have improved significantly:** A combination of negative sentiment around the near-term risk factors, a broader risk-off environment and poor technicals have provided a very unfavourable mix for GGBs in the past weeks. We've seen a near 20pts peak-to-trough correction on the GGB strip as prices retreated to levels last seen at the beginning of the year.

However, we think **valuations have overshot on the downside, making the risk/reward attractive** at this juncture. Besides the favourable long-term outlook, **GGBs also have a uniquely strong position in the capital structure,** in our view. With around 11% of the total debt stock, it is too small to be restructured given that costs more than offset any marginal benefits of a debt reduction.

This leaves the burden of any potential debt relief on the official sector that accounts for nearly 80% of the debt stock. However, instead of principal write-down, the official sector has preferred what we call 'debt equitisation', i.e., extending maturities and reducing/suspending interest payments that alleviate the pressure on debt servicing costs for a significant time to come (see *Greece: From Shake-Up to Shape-Up?* January 21, 2014). Indeed, we estimate that accounting for the 'debt equitisation', the true debt is currently close to 117% of GDP.

**We are not worried about a second restructuring:** The market may be worried about a second restructuring on the back of potential policy discontinuity in case of a change in government. However, we think current prices provide ample compensation. To be clear, our base case contemplates a continuation of soft-OSI and no second restructuring. Probabilities described below are intended to assign likelihood to different scenarios in case the tail risk of second restructuring was to materialise.

Similarly to our previous work, we see three potential restructuring scenarios (see *Greece: Lowering Our Fair Value Estimate, Moving Back to Neutral*, July 9, 2013):

**1. Official sector takes 53.5% principal reduction, no further PSI (70% probability):** We estimate that this could take debt/GDP down to 129%. Greece would become more like Portugal, with a similar debt stock, although better composition, but still a longer and more challenging adjustment path. A premium around 200bp over Portugal may be required by investors for Greek 10-year risk, implying 76% price for the GGB strip.

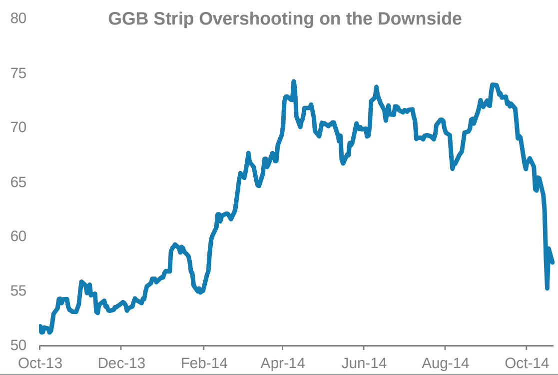
**2. Official sector takes 53.5% principal reduction and shares additional debt relief proportionately with the private sector to reach 90% debt/GDP (20% probability):** We estimate that this would imply about 40% principal reduction for GGB holders in a scenario where official sector loans (with the exception of IMF), ECB/NCB bond holdings and new GGBs would be restructured. Assuming a 6% exit yield, the recovery value would be 43%, we estimate.

**3. Official sector and private sector share additional debt relief proportionately to reach 90% debt/GDP (10% probability):** This would be the harshest scenario for the private sector, as the debt relief provided in the PSI in 2012 would not be taken into consideration, resulting in an overall disproportionate contribution by the official and the private sectors. This would imply about 60% principal reduction for GGB holders, we calculate, in a scenario where official sector loans (excluding the IMF), ECB/NCB bond holdings and new GGBs would be restructured. Assuming a 6% exit yield, the recovery value would be 29%, we estimate.

Hence, **on a probability weighted basis we see valuations at 65% in such a scenario** (current level of the GGB strip 57.50).

### Strong Position in the Capital Structure Should Support GGBs

| | |
|---|---|
| 1. Bonds | 67,122 |
| 1.1 PSI Non-eligible | 750 |
| 1.2 ECB/NCBs | 27,145 |
| 1.3 Holdouts | 3,476 |
| 1.4 New GGBs | 35,751 |
| 2. T-Bills | 13,860 |
| 3. Financial Support Mechanism loans | 220,151 |
| 3.1 IMF | 25,762 |
| 3.2 EU loans | 52,900 |
| 3.3 EFSF loans related to PSI Notes | 34,289 |
| 3.4 Other EFSF Funding | 107,200 |
| 4. Other loans | 19,095 |
| **Total (non-consolidated)** | **320,228** |
| **Nominal GDP** | **182,000** |
| **Debt/GDP** | **175.9%** |
| **Adjusted Debt/GDP** | **117.0%** |




Source: European Commission, IMF, EFSF, Bloomberg, Morgan Stanley Research

**Upside in GDP warrant but mind the deflation risks:** Our model suggests that the GDP warrant at 0.90 trades cheap relative to bonds as fair value is 1.26. Moreover, with the expected drop in GGB yields, the warrants should benefit, too. However, poor liquidity has seen the warrant underperforming the GGB strip for longer periods in the past; therefore, the catch-up may take time. We also see the warrant particularly vulnerable to potential deflation risks as it could severely affect the payouts while the bonds should be more resilient given additional measures to reduce debt should more than offset the impact of deflation on debt sustainability (see here).

**Strategy implications:** Given the improved risk/reward following the recent sell-off, we return to a constructive stance in GGBs. While volatility in the coming months is likely to stay high, current valuations provide adequate protection, in our view. Although prices may not rise back fast to the recent highs, we prefer to be long throughout the volatility and use any potential further dips to add to our position. We are looking for the GGB strip to return back to the mid-to-high 60s for a more balanced risk/reward. The GDP warrant looks cheap, but we favour bonds, due to relatively better liquidity and less unfavourable impact of deflation. Domestic politics remains the key risk to our view.

## EEMEA Equity Strategy *(Ronan Carr)*

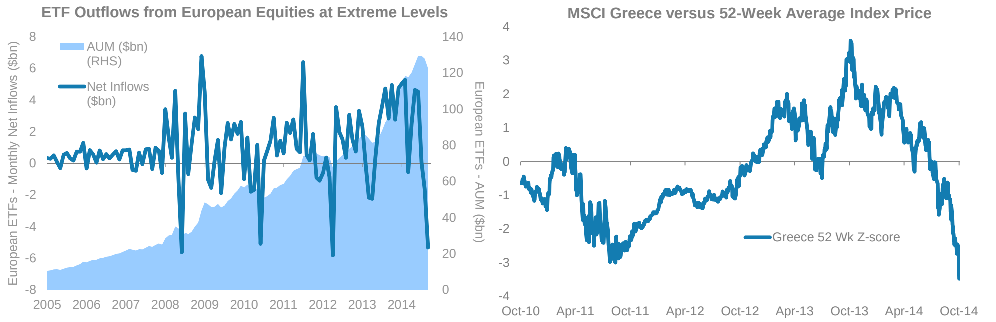
**Greek equities oversold – Overweight:** A combination of concerns has weighed on the market in recent months: weaker growth, political uncertainty, the future of the Greek bailout plan and bank capital. Political newsflow has had a particularly negative impact and looks like it may continue to do so for the next few months. The opposition has extended its lead over the coalition government in recent opinion polls, reigniting concerns about political uncertainty in the lead up the presidential elections in February 2015.

This is driving fears on whether the presidential election may result in a stalemate, leading to national elections further down the road – with potential implications for government policy. Nevertheless, **following the sharp recent sell-off we see value in the Greek market. We therefore retain our Overweight position within MSCI EEMEA,** and highlight the following four points:

**First, we believe risk appetite globally may be set to improve:** Following recent declines, equity markets moved deep into bearish territory on technical and sentiment metrics. In DM, MSCI Europe fell to an RSI of 20 and traded 3SD below the 12-month average – the lowest levels since mid-2001 eurozone crisis.

Indicators such as the US put call ratio at 1.3-1.5, Vix above 25, significant ETF outflows and hedge fund positioning in Europe less than 30% net long all point to markets hitting capitulation levels. **An improvement in risk appetite more generally would benefit Greece, as a recent underperformer.**

## Technical & Sentiment Metrics Have Moved into Capitulation Territory

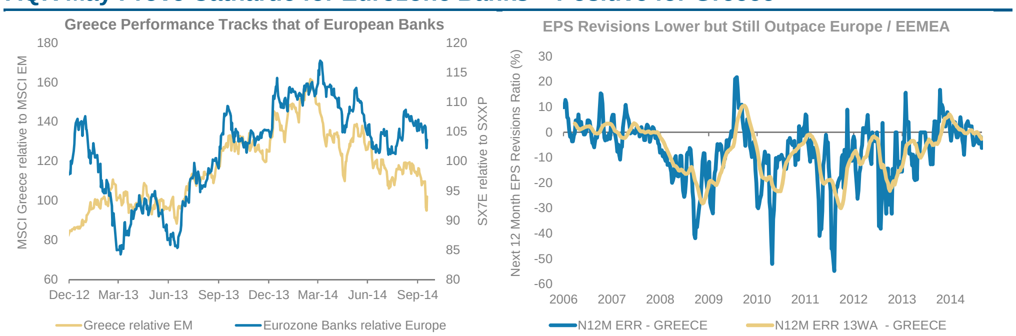



Source: MSCI, Datastream, Bloomberg, Morgan Stanley Research

**Second, Greece itself hit extremely oversold levels:** MSCI Greece Index last week fell to about -3.5SD below the 12-month average price, a reading below trough levels in 2011. Valuations have cheapened significantly too. Using consensus 2015 forecasts, Banks trade on 0.73x PBV. Non-financials trade on 0.96x PBV and 10.7x PE. We note the sharp sell-off across the Greek market – with banks down 43% from their peak but non-financials also trading 29% off their highs. We think the concentration of macro concerns around banks suggests some good value may be opening up in other sectors of the Greek market.

**Third, bank stress tests / AQR are potentially supportive catalysts in the near term:** We see the potential for the AQR to prove more cathartic for the European banking sector than the market expects. That would in turn be supportive for Greece, given the strong correlation of Greek equities to eurozone banks. With respect to Greek banks themselves, investor expectations have increasingly moved towards further equity capital raisings – something our Greek banks analysts believes may be overly pessimistic. Furthermore, Greece would be a beneficiary in the event that recent weakness in the economy and markets leads to any additional policy easing in Europe.

## AQR May Prove Cathartic for Eurozone Banks – Positive for Greece




Source: MSCI, Datastream, IBES, Morgan Stanley Research

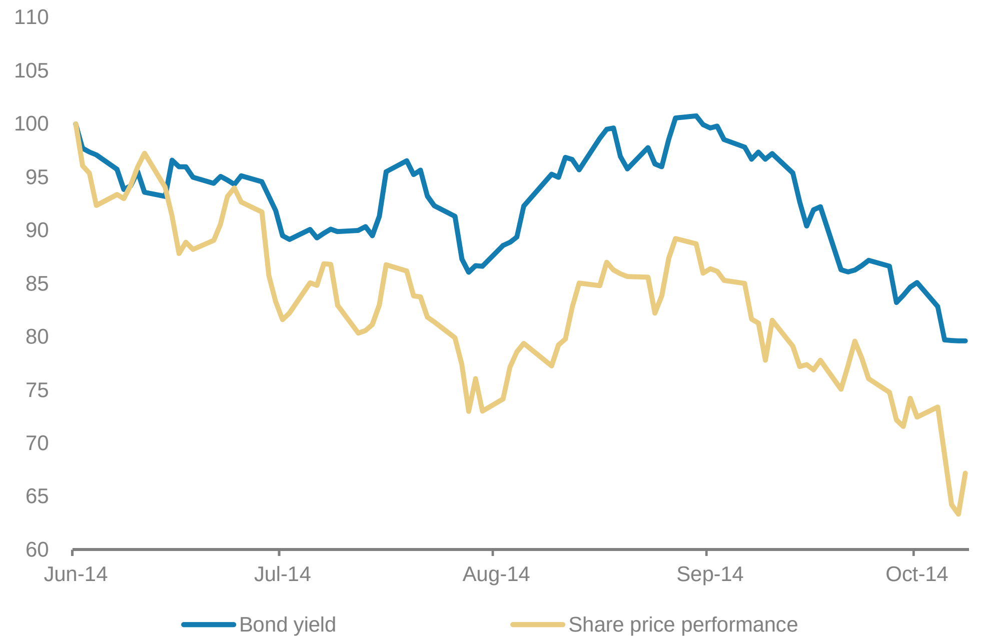
**Fourth, longer-term recovery potential:** As discussed in the economics section of this note, the longer-term recovery story – albeit shallow – remains intact. We continue to expect improved GDP growth in 2015. We also note that earnings revisions trends in Greece have continued to outpace levels in both Developed Europe and EEMEA, although they have weakened modestly in recent months in absolute terms.

### Banks Equity *(Samuel Goodacre, Magdalena Stoklosa)*

**Greek banks remain a top-down trade:** The equivalence of banking risk with sovereign risk means that the economic, policy and political situation remains the key driver for Greek bank stocks. The sector's c.32% decline since its June peak mirrors mounting concerns about weaker growth – with all its repercussions for banks' balance sheets – as well as the future of the Greek bailout plan and political uncertainties. With short-term ROE expectations broadly benign, we note that implied cost of equity has increased by 400bps on average across the banks, which is likely overdone.

Therefore, in line with our macro research colleagues, **we retain our positive longer-term view on Greek banks,** though we remain mindful that macro and political risks are likely to linger, if not deteriorate, into next year. Despite fundamentals playing out positively in line with expectations, we would need to see these risk factors subside to catalyse stock performance from here.

**Sector's c32% Decline Since June Peak Reflects Macro/Political Concerns, Which Need to Subside Before Performance Can Reflect Improving Fundamentals**




Source: Datastream, Morgan Stanley Research

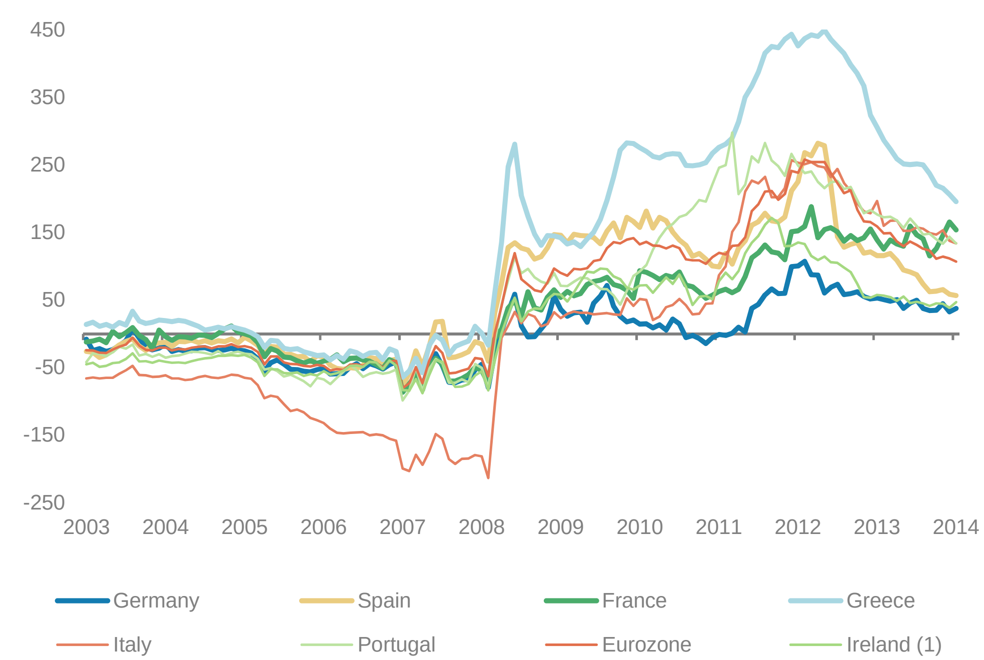
**Compared to our 11% COE, Each 1% Higher COE Impacts Valuations by 7-9%**

| | Current COE | COE +1% |
|---|---|---|
| Alpha | 11.0% | -9% |
| Eurobank | 11.0% | -9% |
| Piraeus | 11.0% | -7% |
| NBG | 11.4% | -7% |

Source: Datastream, Morgan Stanley Research; Prices: Alpha Bank €0.59, Eurobank €0.27, National Bank of Greece €2.05, Piraeus €1.14

**Base case playing out – bank specific fundamentals are improving:** As we wrote in our 2Q report, "Buyers of Alpha and NBG", June 30, 2014, we expect material expansion in net interest margins and gradual improvement in provisioning to drive 11-14% ROTEs across the sector by 2017e. This year to date, we have seen a marked improvement in funding costs, for example, with banks reporting 1H net interest income c.30% higher than last year's levels.

**Normalising Deposit Costs Key to Greek Bank NIMs Expansion**




Note: New Deposits Less than 1 Year Pricing to HHs Rate Spread vs. 3m Euribor.
Source: ECB, Datastream, Bloomberg, Morgan Stanley Research, Data as at August 2014, (1) Ireland is available for total maturity, instead of up to 1 year

Data points remain very positive, and we note that **the latest loan and deposit pricing data indicates continued expansion in loan-deposit spreads;** in August time deposit costs continued to decline, with household deposits down 15bps m/m. Lending yields are declining too, but by a smaller amount (6bps) and, all in, loan-deposit spreads are up by 7bps m/m, now at c.4% compared to 3.6% at the beginning of the year.

**Downside risks increasingly priced in:** We maintain our view that Greek bank capital cushions look comfortable ahead of the European-wide AQR and stress test, as outlined in our report “Value amidst the capital debate”, August 20, 2014. We believe the Bank of Greece / BlackRock 2 stress tests were a good estimate of capital needs as we feel they were thorough and an informed template for the subsequent capital raises. Banks have re-capped to comfortable starting point capital ratios of 16-19%. In addition, the burden of high DTAs looks less of an issue, given the recent rulings on conversion to deferred tax credits. DTAs are equal to 4-7.5% of banks’ core capital, therefore the support they provide to capital ratios should they not have to be deducted is meaningful.

**Conversion of Deferred Tax Asset to Credit, Increasingly Likely, Would Support Capital Ratios by 4-7.5%**

| | Alpha | Eurobank | NBG | Piraeus |
|---|---|---|---|---|
| CET 1 ratio, June 2014 | 16.3% | 17.8% | 16.2% | 14.9% |
| DTAs as % RWAs | 4.4% | 7.5% | 4.8% | 4.0% |

Source: Company Data, Morgan Stanley Research

**Short-term pain, longer-term gain:** Our call is based on macro recovery and a stable political backdrop. As these are still early stage and complex, respectively, they remain key risks to our thesis. However, we think the sector looks attractive after recent restructuring and a clear move to strengthen balance sheets. We would be buyers for base and bull case value, as we outlined in our recent sector initiation: “Greek Banks: Buyers of Alpha and NBG”, June 30, 2014.

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*(as of September 30, 2014)*

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| | Coverage Universe | | Investment Banking Clients (IBC) | | |
|---|---|---|---|---|---|
| Stock Rating Category | Count | % of Total | Count | % of Total IBC | % of Rating Category |
| **Overweight/Buy** | **1113** | **35%** | **353** | **40%** | **32%** |
| **Equal-weight/Hold** | **1390** | **44%** | **410** | **47%** | **29%** |
| **Not-Rated/Hold** | **109** | **3%** | **21** | **2%** | **19%** |
| **Underweight/Sell** | **575** | **18%** | **96** | **11%** | **17%** |
| **Total** | **3,187** | | **880** | | |

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

### Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's

industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

### Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.
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