



## K2 Perspective

### Greece: Stuck in the Middle

*Well I don't know why I came here tonight... Joined the Euro?*

*I got the feeling that something ain't right... \$300+ billion in debt obligations*

*I'm so scared in case I fall off my chair... Leave the EU?*

*And I'm wondering how I'll get down the stairs... Reissue the Drachma?*

*Clowns to the left of me... Political promises (Syriza)*

*Jokers to the right... debt obligations (Germany, EU)*

*Here I am stuck in the middle with you... Greek government*

*Yes I'm stuck in the middle with you... Greek people*

**Rafferty, Gerry. "Stuck in the Middle". Stuck in the Middle. LP. A&M Records, 1972**

#### **Greece, stuck between political forces on the left (Syriza party) and fiscal forces on the right (debt burdens, EU austerity controls, etc.). Is there a viable way out? What are the options?**

Periodically when commuting home in the evenings (sometimes nights ... occasionally mornings) I have the opportunity to listen to a bit of music. In my experience the songs that resonate with me most are those typically associated with meaningful memories or events from days gone by. Sappy 70's glamour band ballads for example, invoking awkward recollections of grade-school dances (yikes...). On a recent drive I was accompanied by the above referenced classic tune from Stealers Wheel. In the past the association for this particular diddy had always been Quentin Tarantino's 1992 masterful debut film *Reservoir Dogs*, but this time around it was different. This time a new muse entered the mindscape...the current situation in Greece.

#### **The Greek Odyssey: How we Got Here**

To understand where we are with Greece and what can potentially happen we need to understand what got us here in the first place. Let's summarize the situation for context — at least as it pertains to finance. With regard to Greek literature you are on your own.

Roughly four years ago Greece fell into crisis. Its debt-to-GDP ratio was about 120% and interest rates on Greek 10-year bonds spiked (going as high as 48.6%) as investors worried about default. It was clear at the time that Greece could not pay its debt. After much hand wringing and last minute negotiations (sound familiar?), the Greek government, European Commission, and the European Central Bank ('ECB') collectively agreed to a support package. We wrote about it in the February 2012 *Perspective*:

*... While the latest response to the debt crisis has succeeded in buying time for the future of Greece in the European Monetary Union ('EU'), the general consensus among economists and analysts is that time is all that it has bought...certainly not sustainability. Given this latest support package requires even further austerity measures, which in turn will make the challenge of reaching fiscal balance even more difficult to obtain, is the writing ultimately on the wall? Is Greece staying in the EU a viable option long-term? To employ one of the more amusing colloquialisms to emerge from American pop culture in recent years, has the Greek story as it pertains to the Euro 'jumped the shark'<sup>1</sup>?*...

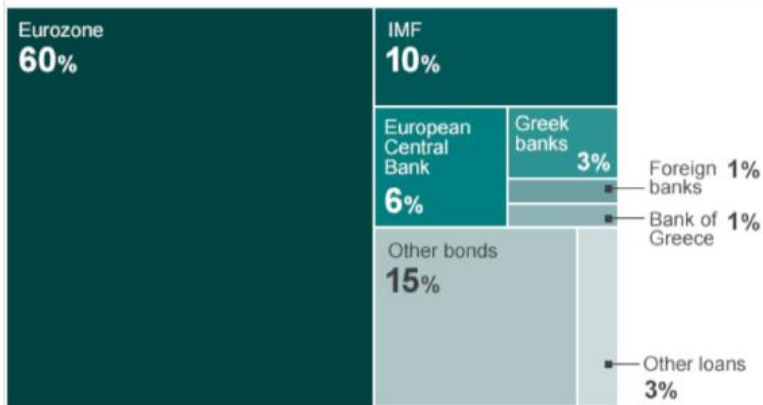
1. According to urbandictionary.com, the phrase 'jump the shark' signifies 'the precise moment when you know a program, band, actor, politician, or other public figure (we would add Euro zone member country to this list as well) has taken a turn for the worse, gone downhill, become irreversibly bad, or is unredeemable.' The expression derives from an episode of the 1970's American television sitcom *Happy Days*, where a water-skiing Fonzie (Henry Winkler), wearing swim trunks and his trademark leather jacket, jumps over a confined shark, answering a challenge to demonstrate his bravery. For a show that in its early seasons depicted universally relatable experiences against a backdrop of 1950s nostalgia, this marked an almost cartoonish turn towards attention-seeking gimmickry. The series continued for nearly five years after that, with a number of changes in cast and situations. However, critics of the show have suggested that the shark jump episode marked the beginning of the end. Out of ideas and perhaps victimized by its own success (largely due to the disproportionate popularity of the increasingly superhuman 'Fonzie' character), the show became a caricature of itself before its ultimate demise in 1984.

So in 2012 the panic was diffused temporarily, everyone breathed a sigh of relief, and Greek interest rates fell to levels even lower than before the crisis. Of note, the EU's decision to bail out Greece was not an entirely altruistic move, as the vast majority of what was owed was to French, German, Italian, and other core banks. So a support to Greece was at the time really a support to the entirety of Europe.

Self-interested gestures aside, fast forward to today and we find ourselves essentially in the same predicament. While some role players have changed (enter the Syriza party...more later), circumstances have generally not with regard to the Greek debt burden. For the most part Greece and the EU are right back where they started, except this time the core European banks are better insulated.

### Total Estimated Greek Debt €323bn

#### Who Does Greece Owe?



Source: BBC

We have arrived at this circular juncture because the 'solution' established in 2012, as we highlighted in our letter, did little in terms of long term sustainability. In fact quite the contrary. Greece has been pushed further into depression, with its GDP falling by 25% and unemployment rising to 25% (nearly 60% among its youth) according to statistics from the IMF. Currently Greek debt-to-GDP is roughly 175%, and the country is again faced with the prospect of not being able to meet its debt obligations.

### Enter Syriza

In January of 2015 the Greek electorate, frustrated with years of imposed austerity and not seeing much in the way of progress economically, decided that they wanted change. They voted the left-leaning Syriza party into office on the back of campaign promises to reverse many of the EU mandated austerity measures that were implemented as part of the 2012 bailout agreement.

The Syriza view is that the austerity that Berlin and the rest of Europe demanded in 2012 was unreasonable, making it more difficult in the long run for the county to address its debt burden. Greece's new finance minister Yanis Varoufakis in fact publicly raised the issue of renegotiating Greece's \$365 billion in debt, and is pushing for relief in the way of longer maturities, lower interest rates and repayments linked to the country's economic growth.

In response Germany has made it very clear that restructuring of the debt is not an option, and other Euro zone members have generally presented a united front in this regard. In addition, stringent austerity measures would still be attached to any Greek bailout package in the future. For Syriza, however, this is not an option.

**So politically it seems we have reached an impasse; on one side we find German Finance Minister Wolfgang Schauble, and on the other we have the Greek electorate and Syriza party. Stuck in the middle are Greek Prime Minister Alexis Tsipras and his compatriot Finance Minister Yanis Varoufakis, faced with the seemingly insurmountable dilemma of trying to give the Greek people their cake while allowing the rest of Europe to eat it as well.**

That is to say they are faced with trying to serve two masters; opinion polls show that many Greek voters support Athens' tough negotiation tactics. But the polls also show that most Greeks want their country to remain in the Euro zone...but to do so would require agreeing with the zone's austerity demands. This would be the technical definition of a pickle.

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## Falling off the Chair: A Greek Exit from the Euro?

The relationship between Greece and the rest of Europe (Germany) has grown considerably more contentious in recent weeks, certainly more so than the first time a risk of default surfaced several years ago. The tone between the two countries has ranged from irritable to irrational; with Greek news media casting Ms. Merkel and her counterparts as fascist imperialists intent on using Greece as the EU doormat, while German media portrays the Greeks as happy-go-lucky wastrels happy to squander away the core's industrious wealth.

While a so called 'Grexit', as Greece's potential Euro zone departure has come to be known, is still not something that is being referenced publicly on either side, it does seem like it is a more realistic possibility today than it was in the past. Has Greece 'jumped the shark'?

### Grexit Scenarios: The Impact on Greece

Some members of Syriza believe that the best option for Greece to regain its financial independence would be to default on its debts and cut loose from the Euro. I am not sure this would be the best approach (and I envision Tsipras as the ancient Greek mythological hero Odysseus trying to resist these siren calls by tying himself to his ship's mast), but let us consider the potential impact of such an action.

As Syriza imagines, on the surface this may seem like an attractive option. Presumably the Greek debt would be cut to more manageable levels, and bringing back the drachma would allow the country to devalue its currency and strengthen its competitiveness. This is the utopian vision. The reality, in my view anyway, is a bit more nightmarish.

The new currency would likely depreciate dramatically in value against the Euro. Banks could totter, cash machines would be empty, interest rates would probably spike and companies would go bankrupt. Credit insurer Euler Hermes predicts that insolvencies would rise by 50% in 2015 and again an additional 30% in 2016. Even the country's largest electricity utility company, state-owned PPC, would likely go bankrupt, predicts Standard & Poor's. So no lights. Would business have liquidity to bring in vital commodities like oil, medicine, and food? Tax revenue would probably plummet, and the newly insolvent government would not be able to borrow abroad. International investor faith would be shaken, and it is probable Greece would not be able to raise money for several years. Indeed, rather than helping the debt problem initially, analysts at Germany's Commerzbank predict that a Grexit would result in the debt burden rising from the current level of 175% to 230% of GDP. This would be a true depressionary environment.

How would the citizenry respond? Argentina's declaration of bankruptcy in 2001 saw violent riots and looting. The Argentina example also shows how long it can take for an economy to recover. Tens of thousands of Argentines left their country. Would many Greeks do the same? Envisioning this situation going from bad to worse, the Syriza government (which was voted in on a promise to increase spending) could simply choose to print more drachmas to fill the financial hole; perhaps fueling a dangerous hyperinflation?

### Could Greece default on its debt while staying in the Euro?

Possibly, but this outcome would still result in misery for the country and its citizenry. The Greek banking system would still be bankrupt, the financial institutions would still not be able to get funding from the Euro zone to recapitalize the banks, and the only alternative would be to 'bail in' depositors — offering shares in the banks as collateral for the deposits. This would also entail capital controls. In the interim the government would still be trying to balance its budget, a daunting prospect given that the collapse of the financial system would all but crush economic growth. Madre de dios...

### Grexit Scenarios: The Impact on Europe

What about for greater Europe? What would Greece's departure mean for the core?

Initially the impact would probably be manageable. Longer term, of course, consequences are more difficult to ascertain, but certainly they could be meaningful. I imagine the European Stability Mechanism could be used in the beginning as a backstop in case of any spillover effect with other periphery nations. I view these countries as much less susceptible than they were in 2011 to Greek risk; while yields on Spanish and Italian government bonds may increase slightly following a Grexit, the possibility of a crash appears minimal.

Naturally there would be financial losses for partner countries. The European bailout fund and IMF have provided roughly €300 billion to Greece over the years. Germany directly or indirectly guarantees almost €65 billion of these loans. If Greece leaves a large part of this money would probably evaporate with its departure.

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## **On the other hand, the political risk to Europe/Germany would be significant. A Greek exit represents a defeat for EU political leaders.**

For five years they have worked diligently to keep Greece in the EU at any price. In the end, leaving would be an almost incalculable economic risk for Greece, but one which could pay political dividends. The exact opposite is true for the rest of Europe. Politically for Europe it would be an abject failure.

And, while they do not want an exit, Germany is also worried that making concessions to Syriza would increase the popularity of other anti-system parties throughout the Euro zone. Spain, Portugal and Ireland — countries that have received bailouts in recent years — will hold elections between late 2015 and early 2016. Berlin fears that if Syriza can successfully renegotiate Greece's debt, other governments will demand similar concessions in the future.

This also explains why the current conservative governments in Madrid, Lisbon and Dublin have taken a hard stance against Greece's requests for debt relief. These governments have defended austerity measures in the past and cannot support concessions for Greece that they did not request for themselves. From the EU perspective, it is politically impossible to accept an overt debt haircut on Greece's outstanding obligations at this point. It is also politically and economically undesirable to allow Greece to leave. Stuck in the middle...

### **What should Greece do?**

Let us assume we are Greece. Setting aside the moral/ethical implications for defaulting on one's obligations, and the short term pain, from a purely utilitarian standpoint (or Machiavellian) — maybe in the long run it just makes better sense for Greece to exit the Euro? Again, I am not suggesting this is the best course of action...we are just spit balling here. But let us think this through...Eventually Greece would be allowed back into the bond market, as unlikely a reality as that may seem currently. If there is an industry with an absolute lack of historical perspective, it is finance.

Greece could balk on its debt and return to the drachma, let the market set the value on the currency, and then work to get its fiscal house in order (a daunting prospect we know).

### **Another interesting approach: According to the CIA World Factbook tourism represents 18% of the Greek GDP. Why not try and make it 25% or 30%? Make Greece the most compelling, best value, most pleasurable destination in Europe.**

Certainly the dollar to Euro exchange rate is an enticing incentive for those consumption minded Americans...(and I do mean consumption!!). At a minimum Greece has got the topography part nailed down, the food is outstanding, and certainly its citizenry are as hospitable and friendly as there are in the world. If Greece committed to a tourism drive, and to treating each visitor like a king bringing gold (because essentially that is what they would be), the country could do quite well for itself in terms of GDP.

If a business wants to open a factory in Greece, make that happen, give all of the incentives you can to encourage foreign investment. Minimize red tape, just entice corporations to bring their money and jobs and the Greek government will take care of the rest.

While it would be difficult, there are a plethora of examples of countries that have done the same with much less, certainly without the natural geographic advantages afforded Greece by mother nature.

In the end, all we can do is position our portfolio's prudently and wait to see what happens; the ultimate outcome at this stage is very difficult to know. What I do know is that the next time I hear the song 'stuck in the middle' on the radio I will think of Greece and the EU before I think of Quentin Tarantino. Perhaps you will as well.

Thanks for reading.

**Brooks Ritchey**

**SVP, Director of Investment Solutions, K2 Advisors**

## Index Definitions

**T-bills:** A short-term debt obligation backed by the U.S. government with a maturity of less than one year. T-bills are sold in denominations of \$1,000 up to a maximum purchase of \$5 million and commonly have maturities of one month (four weeks), three months (13 weeks) or six months (26 weeks).

**S&P 500 Index:** Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

**Swiss Re Cat Bond Index:** The Swiss Re Cat Bond Total Return Index tracks the total rate of return for all outstanding USD denominated cat bonds. The index is based on Swiss Re pricing indications only.

**ML High Yield BB Index:** The ML benchmark index for BB-rated high yield corporate bonds.

**The BofA Merrill Lynch US Floating-Rate Asset-Backed Index:** is a statistical composite tracking the overall performance of the US floating-rate asset-backed securities (ABS) market over time. The index includes US dollar-denominated ABS having a floating coupon, a minimum amount outstanding of \$25 million and an investment grade credit rating of BBB or higher.

**BarCap U.S. Inflation Linked Bonds over 5 Year TR:** A part of the Barclays Capital family of global inflation-linked bond indices, the Barclays Capital US Government Inflation-linked bond index (US TIPS) measures the performance of the TIPS market. TIPS form the largest component of the Barclays Capital Global Inflation-Linked Bond Index. Inflation-linked indices include only capital indexed bonds with a remaining maturity of one year or more.

**US Treasury Bill 90-Day On-The-Run Yield:** Measured in percentage yield, this is the interest yield payable per year on the most liquid U.S. 3 month Treasury Bill.

**The Dollar ("DXY") Index:** indicates the general international value of the USD. The USDIX does this by averaging the exchange rates between the USD and 6 major world currencies. The FINEX computes this by using the rates supplied by some 500 banks.

**The EurekaHedge ILS Advisers Index:** is an equally weighted index of hedge funds that explicitly allocate to insurance linked investments and have at least 70% of their portfolio invested in non-life risk.

**HFRI Fund of Funds Composite Index:** Funds of Funds invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio. A manager may allocate funds to numerous managers within a single strategy, or with numerous managers in multiple strategies.

**BarCap U.S. Agg TR Unhedged USD:** The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passsthroughs), ABS, and CMBS sectors.

**BarCap U.S. Long Treasury TR Index Unhedged USD:** The Barclays US Treasury bond index is part of Barclays Capital global family of government bonds indices. The index measures the performance of the US Treasury bond market, one of the largest and most liquid government bond markets in the world. Using market capitalization weighting and a standard rule-based inclusion methodology; the index accurately reflects the performance and characteristics of the Treasury market and provides a basis for customized indices.



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