Investment Notes

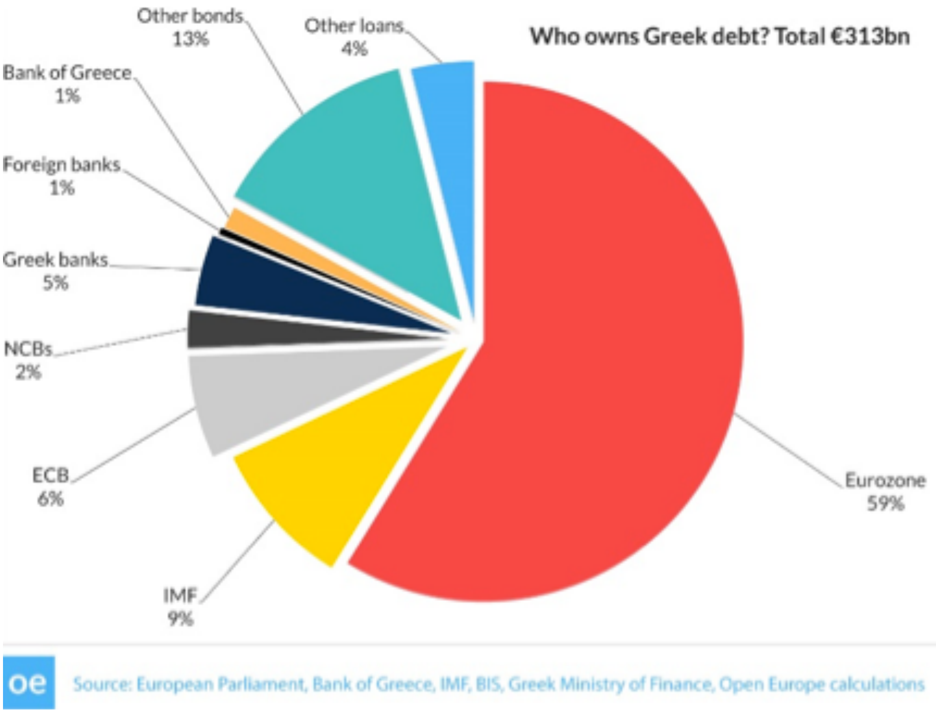
July 2015

By now most people know that voters in Greece rejected the terms of the bailout package offered by the European Union (Οχι = no), the European Central Bank and the European Commission to tighten the austerity screws even more to keep the international money tap open for the Greeks.

Many Greeks have celebrated the result of the referendum as a victory by the man the street over faceless bureaucrats and bankers. Greece has been in a depression for more than 5 years and in a democracy, voters can be expected to look for an alternative approach.

Greece failed to repay $1.72 billion to the International Monetary Fund on 30 June. A further €3.5 billion is due to be repaid by Greece to the European Central Bank on 20 July.

Europe now has exposure of approximately €325 billion to Greece through a number of channels. Official creditors in the form of Eurozone, ECB and IMF account for 76% of Greece's public debt. This exposure has significantly increased over time, while the balance has been shifted from the private sector to the public sector via the bailouts and debt restructuring in 2012.



WHERE DID THE CRISIS START?

The reasons for the financial calamity in Greece is complex, but can be traced back to excessive borrowing by the Greek government after European Monetary Union in 1998. There are also arguments that monetary union was misrepresented to voters. The terms of accepting/entering the Euro currency perhaps was also to generous or manufactured. The borrowing for the Olympic Games also did not help.

A significant portion of the Greek economy is cash-based off the books and untaxed. Until recently, Greeks could retire with a 100% pension as early as age 57 years. To deliver services and fund obligations, the Greek government had had to borrow from the international community. Greece maintained its Government Debt to GDP ratio at already high levels of approximately 100% until 2008, but the worldwide economic recession resulted in the Government Debt to GDP ratio to increase to 177%.

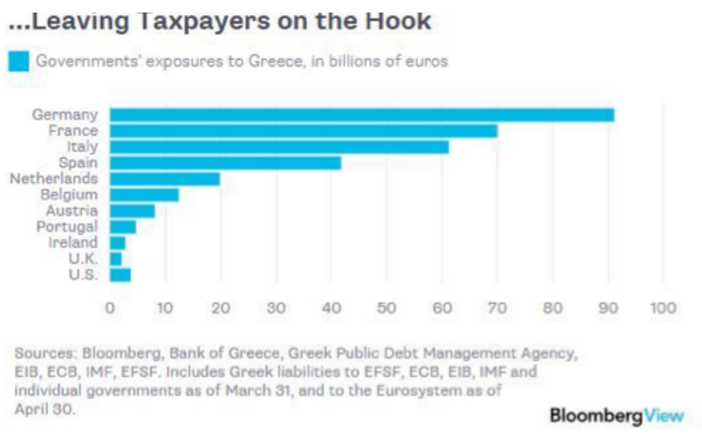
This means that while the size of the economy shrunk by 25%, government debt increased by 32% since 2009.

International lenders responded by advancing further loans to Greece - on condition that it improves its fiscal position, i.e. raise more taxes and spend less on services. The government took some steps such as increasing the retirement age (it will reach 68 years by 2030), cutting back on pensions and reducing services to the population, but crucially, it failed to improve its tax base significantly. Many Greeks still have off-the-book earnings, which they fail to report and on which they do not pay tax.

The Greeks are not keen to accept more economic hardship and rejected the terms offered for further support. Europe must now decide whether they will accept responsibility for Greece's indiscretions, or whether Greece will be held to account.

WHAT TO DO?

1. Negotiate better terms with the Europe and the banks. In essence, this means that countries such as Germany where a strong work ethic prevails will be expected to financially support Greece, which is perceived to maintain a much more relaxed work ethic. It will be interesting to see how Germany and its allies respond to renewed Greek overtures.



2. Could have exit the European Monetary Union (Euro). This will be painful for both Europe and Greece, as Greece will have re-introduce the Drachma, leading to a volatile and dangerous era for Greece.

   The Drachma would de-value strongly and Greece could experience run-away inflation. Greece will in essence "inflate" their way out of debt. Imported goods will then become very expensive and the Greek economy, even though smaller than previously, will become off the books even more than presently. This could lead to more political instability in a country where political coups are not uncommon.

3. The Greek population could accept economic hardship now, improve their tax base and fix their economy. Voters roundly rejected this option.

WHAT DOES THIS MEAN FOR A SOUTH AFRICAN RETIREMENT FUND MEMBER?

As the Euro is expected to weaken, the US Dollar will remain strong. We do expect international investors to tighten their assessment of both country and credit risk and this may lead to some volatility in markets.

The Rand has weakened significantly in the past four years against the dollar but not as much against the Euro. Recently it has held its value against the Euro. The Rand is expected to remain lacklustre but more due to internal capacity constraints like electricity, resource prices, logistics and education, rather than the impact of Greece on the Euro.

We have seen that since the third quarter of 2014 South Africa has experience portfolio outflows, which continued in the first half of 2015. This aspect together with continued negative trade balances has put pressure on the Rand.

Even though South Africa has a significant element of imported inflation, and we can expect interest rates increases due to inflation, interest rates are still relatively low. We expect share prices to remain at relatively high valuation levels.

Bonds yields in South Africa are likely to remain unaffected.

The conclusion is that South African retirement fund savers may see initial instability, but remain largely unaffected.

We recommend that retirement savers maintain their long-term investment strategies.

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