I have written two columns in the past four months on the topic of Greece, and in between the two, my mood shifted from brightly optimistic to cautiously optimistic, as I was more than a little shocked by the belligerence of the various participants in this drama. In this column, I continue my exploration of this modern day odyssey, but with a heavy heart. As of today (Monday, July 13), Greece has essentially capitulated to every single demand made by its creditors, on terms measurably worse than it was offered just two weeks earlier, after Prime Minister Alexis Tsipras made an enormous and irresponsible gamble with his country’s people and its fortunes and called a referendum on those terms, one that he likely hoped to lose. In the ensuing aftermath of the resounding OXI or NO (though the exact question on which the Greek people voted has never been entirely clear), the European Central Bank (ECB) cut off its funding to the Greek banking system, which almost instantly had to shut down, restricting cash disbursements to €60 per day.

With the benefit of hindsight, the quarrels of the past six months have done little other than to inflame passions, damage relationships between member states of the European Union, and stop dead in its tracks a nascent recovery in a fragile economy. It has also reawakened old and ugly stereotypes about the Germans, which the European Union and the euro were supposed to dispel permanently. Mr. Tsipras offered his constituents a meaningless sound bite after his eventual capitulation: “We put up a hard fight for the past six months and fought to the end in order to get the best out of it, to get a deal which will allow the country to stand on its feet and the Greek people to keep fighting.” He now has to sell the onerous terms to his fractious coalition and to Greek citizens by arguing that it could have been much worse.

Over the weekend, he lost his parliamentary majority, and he will likely have to form a government of national unity before calling new elections in the fall. It is not clear if he will remain prime minister and what kind of government will follow the current one. This will surely go down in history as one of the most poorly managed negotiations of this century, both in terms of its tone and its substance, and also for the near-complete lack of clarity in the explanations that voters across the continent have been offered by their elected representatives. Pollsters have been polling and voters have been voting on caricatures – some true, others false, and yet others both false and ugly.

In fairness, it must be said that Mr. Tsipras gambled recklessly with his country’s people and its fortunes, and many of the reforms that the creditor nations insisted on would have to be put in place anyway, regardless of whether or not Greece stayed in the euro, but the absence of debt relief in the final agreement is both disheartening and short-sighted, less so for economic reasons—the interest rate on Greek government debt is low, and most of the debt is to be repaid only in the distant future—than for psychological ones. It would have given the Greek people a visible sign that the sacrifices they are going to have to make had been acknowledged by their creditors. It would have also given them some comfort knowing that Europe wanted them to succeed and was making an effort to help them along their rocky road.

European stocks have rallied nearly 9% since the middle of this past week, the German 10-year rate has backed up 25 basis points, peripheral spreads have compressed between 30 and 50 basis points, and Greek government bonds and credit default swap spreads have rallied sharply. Investors have clearly voted with their wallets. But now comes the hard part. The Greeks have to do in a few short years what took Germany the better part of a decade: implement the Greek equivalent of the Hartz reforms and start growing again, so that the burden of debt relative to GDP steadily diminishes. It remains to be seen if this will happen. If it does, Greece will become the new Ireland. If not, it will slide inexorably toward Grexit. I, and many others, wish them well in their hour of need, and hope for the first outcome, not for the second.
Weekly Commentary: Greece in the Abyss
Week Ending July 10, 2015 - 2

Next Week:

Monday, July 13:
- Japan Tertiary Industry Activity growth is expected to decrease to -0.3% m.o.m. (s.a.) for May.

Tuesday, July 14:
- UK CPI growth is expected to decrease to 0.1% m.o.m. (s.a.) for June.
- Eurozone Industrial Production growth is expected to increase to 0.2% m.o.m. (s.a.) for May.
- US Retail Sales Advance monthly change is expected to be 0.3% m.o.m. (s.a.) for June.

Wednesday, July 15:
- UK Monthly Jobless Claim Change is expected to be -9,000 (s.a.) for June.
- US PPI Final Demand growth is expected to decrease to 0.2% m.o.m. (s.a.) for June.
- US Industrial Production growth is expected to increase to 0.2% m.o.m. (s.a.) for June.

Thursday, July 16:
- Eurozone CPI growth is expected to decrease to 0.0% m.o.m. (s.a.) for June.

Friday, July 17:
- US Housing Starts are expected to increase to 1,150,000 (s.a.a.r.) for June.
- US CPI growth is expected to decrease to 0.3% m.o.m. (s.a.) for June.

Source: Bloomberg, as at end July 10, 2015

Central Bank Watch:

<table>
<thead>
<tr>
<th>Central Bank</th>
<th>Last Move</th>
<th>Date of Move</th>
<th>Current Policy Rate</th>
<th>Implied 3-Month Rate on September 2015 Interest Rate Futures Contract</th>
<th>Next Meeting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fed</td>
<td>-75 bps</td>
<td>December 16, 2008</td>
<td>0% - 0.25%</td>
<td>0.17%</td>
<td>July 29</td>
</tr>
<tr>
<td>ECB</td>
<td>-25 bps</td>
<td>September 4, 2014</td>
<td>0.05%</td>
<td>-0.15%</td>
<td>July 16</td>
</tr>
<tr>
<td>BoJ</td>
<td>-20 bps</td>
<td>October 5, 2010</td>
<td>0% - 0.10%</td>
<td>0.17%</td>
<td>July 15</td>
</tr>
<tr>
<td>BoE</td>
<td>-50 bps</td>
<td>March 5, 2009</td>
<td>0.50%</td>
<td>0.62%</td>
<td>August 6</td>
</tr>
</tbody>
</table>

Source: Bloomberg, as at end July 10, 2015
Market Review: Sovereign Bond Markets

United States

Not surprisingly, the market’s attention continued to remain on the Greek debt crisis. The outcome of the Greek referendum—a clear rejection of more austerity policies by the Greek people—in conjunction with an equity market meltdown in China led to a risk-off rally in Treasuries in the earlier part of the week. The 10-year nominal yield fell to as low as 2.19% before selling back to 2.4% on Friday, July 10, as Greece’s proposal to adopt most of the austerity measures recommended by its creditors was viewed positively by the market.

In economic data, the services sector of the US economy continued to show strong growth as indicated by the ISM Non-Manufacturing Index, which came in at 56.0. On the employment front, initial jobless claims for the week rose to 297,000 from 281,000 in the previous week.

Source: Bloomberg

Europe & Japan

In a week without important economic data points, markets were again whipsawed by developments in Greece. At the beginning of the week, after the offered bailout program was rejected in the Greek referendum with a large majority, markets reacted accordingly with a solid rally in German bunds down to 0.6% and notable spread-widening in the periphery. Talks between all parties involved were stopped and preparations for Greece leaving the Eurozone started. Nevertheless, towards the end of the week, headlines suggested that Greek Prime Minister Tsipras had changed his stance and was now willing to accept the conditions of the Institutions for a new support program. Risks for an uncontrolled “Grexit” have therefore fallen. As a consequence, peripheral spreads compressed markedly, and bund yields rose sharply, ending the week at 0.9%, up 10 basis points for the week. Negotiations will continue over the weekend, and the results will be a crucial input into the ECB’s discussion on Monday, July 13, about how to proceed with the emergency liquidity assistance.

In Japan, economic data was mixed this week as the Economy Watchers Survey weakened for the first time in seven months, while strong machinery orders provided additional support for the solid outlook for capital spending following the optimistic Tankan Survey results released in the prior week. Taken together, recent data points indicate downside risks to the current consensus for second-quarter GDP growth, and a negative print now looks possible. Consumption has started to pick up, but not strongly enough to offset previous weakness. Further, falling exports suggest a negative contribution from net trade. The yields on 10-year JGBs fell approximately four basis points over the course of the week to 0.45%.

Source: Bloomberg
Weekly Commentary: Greece in the Abyss
Week Ending July 10, 2015

Market Review: Emerging Markets (EM)

The week was a volatile one for EM debt, with external factors driving markets, but overall leaving them roughly back to where they started. The two key themes grabbing investor focus were the ongoing Greek debt crisis and possible exit from the euro, and the precipitous fall in the Chinese equity market and what that means for growth and policy. EM sovereign debt in both local currencies and US dollars rose four basis points in total, recovering after a plunge earlier in the week. For the former, rates and foreign exchange netted out close to zero, but returns at the regional and country levels showed a bit more dispersion. For external bonds, high-yield bonds outperformed very slightly, and only a few countries stood out, mainly as a result of the drop in the price of oil.

Eastern Europe local rates, spreads and foreign exchange staged a strong rally following underperformance over past weeks. While the direct economic ties between the majority of these countries and Greece is fairly small, investors preferred core Europe as the negative headlines on the negotiations and Greek debt referendum played out. Value-seeking investors saw opportunity, however, pushing Hungarian and Romanian total returns above 2% for the week. Elsewhere, with oil again reaching levels close to US$50 per barrel, highly exposed countries, primarily in Latin America, saw sharp increases in spreads.

Source: Bloomberg, Barclays Research

Market Review: Global Inflation-Linked Bonds (GILBs)

In the US, breakeven inflation (BEI) spreads started the week lower due to the Greek debt crisis, the collapse in the Chinese equity market, as well as the dramatic decline in crude oil prices (the active West Texas Intermediate (WTI) crude oil price fell from US$57 per barrel at the close of the previous week to as low as US$51.50 per barrel in the middle of the week). The 10-year BEI spread fell to as low as 184 basis points, before a rebound in risk sentiment later in the week—following increasing prospects of a Greek deal—led it higher to 188 basis points.

In the UK, BEI spreads ended the week almost unchanged from the previous week after dropping earlier in the week due to declining risk sentiment. Apart from global headlines, the market’s attention was also on upcoming supply: the Debt Management Office (DMO) announced a £1.5-billion size for an auction of IL26 in the coming week. It also announced that planned gilt sales for FY2015-16 are being reduced by £3.5 billion, of which £900 million come from a reduction in index-linked gilt auctions.

In the Eurozone, BEI spreads in both the core and periphery declined significantly in the earlier part of the week following the outcome of the Greek referendum. The 10-year German BEI spread declined to 124 basis points, almost eight basis points lower from the close of the previous week. However, prospects for a deal later in the week led to a partial recovery, particularly in peripheral BEI. Amid the market volatility, the German Finance Agency tapped €1 billion of DBR€126s. However, the amount tendered was only €955 million, due to the prevailing market volatility.

Source: Bloomberg

Market Review: Currency Markets

G10

G10 currencies closed within 1% of where they opened the week, even despite risk aversion and increased volatility surrounding developments in Greece. The Japanese yen traded in the most dramatic fashion as it rallied in lockstep with US Treasuries to a three-month high on a strong safe-haven bid. By the end of the week, however, the Japanese currency had given back all its gains as US Treasuries declined amid optimism regarding the Greek situation as well as hawkish comments from Federal Reserve Chairwoman Yellen. The New Zealand dollar was the top performing currency as risk-aversion drove an unwind of large short positioning in the currency. Its counterpart across the Tasman sea was the worst performer of the week as iron ore, Australia’s largest export, hit a fresh three-month low due to volatility in Chinese equity markets and Chinese growth concerns.

Source: Bloomberg
Market Review: Money Markets

The minutes from the June Federal Open Market Committee (FOMC) meeting were released this week, showing that most Fed participants believe that the US economy is improving and will reach full employment by year-end. However, these accounts were overshadowed by concerns among many policymakers with regards to uncertainty in Greece and the instability in the Chinese equity market. In a speech on Friday, July 10, Fed Chair Yellen did acknowledge global headwinds, but said with regards to the US, “it will be appropriate at some point later this year to take the first step to raise the federal funds rate and thus begin normalizing monetary policy.” Money market investors hold little to no exposure to Greece and China, and thus have been unaffected by global affairs. With the possibility of short-term rates starting to rise later this year as the Fed gets set to tighten monetary policy, investors continue to favor floating-rate notes. Six- and seven-month floating-rate bonds indexed to one-month LIBOR with spreads between 14 and 20 basis points accounted for over 90% of the volume this week.

Sources: Wall Street Journal, Federal Reserve, JP Morgan

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

It was a rollercoaster ride in the corporate credit sector this week, with risk-off concerns at the start and risk-on sentiment towards the end of the week. The Greek drama continued its hold, but China started to get more attention as a possibly bigger issue. The situation in China had commodities feeling the pain, and it was reflected in the metal and mining names. Further, WTI crude oil prices moved to recent lows, and energy bonds, particularly high beta names, declined. Risk-on sentiment took over towards the weekend as both issues of concern headed in a more positive direction. Primary market activity picked up in the second half of the week in the investment-grade sector, but the high-yield sector had its first quiet week since July 2013 with no deals. The investment-grade sector priced US$28 billion, with the bulk priced on Thursday, July 9, with the launch of a six-tranche deal for US$16 billion by Charter Communications to finance its takeover of Time Warner Cable. The deal attracted both investment-grade and high-yield accounts. The book on Charter was approximately US$48 billion, indicating there is still a lot of cash out there. Secondary market volume was light overall, but firmed up at the end of the week due to optimism on Greece. Yield to worst for the investment-grade index widened three basis points w.o.w., and it widened 11 basis points w.o.w. for the high-yield index.

Sources: Barclays Capital, JP Morgan, Credit Suisse

Mortgage-Backed Securities

US interest rates were volatile over the course of the week as global macro events in Europe and Asia left investors unsure of the general direction of the market. The mortgage sector underperformed duration-matched Treasuries as the aforementioned market volatility continued to take its toll on spread products. The release of the June FOMC minutes revealed that the Fed remains cautious about a premature decision to begin normalizing its policy, continuing to raise doubt about the possibility of a September rate hike. The June prepayment report showed little change in aggregate prepayments, as 30-year conditional prepayment rate increases across the three agencies ranged between 1% and 2%. The Mortgage Bankers Association of America (MBA) Refinance Index is currently hovering around its low for the year at 1.350. The drop in refinancing, however, was offset by a pick-up in prepayments due to seasonal factors and an increase in the monthly day count. We remain optimistic about the MBS sector as we expect prepayments to slow in the coming months, with the impact of higher mortgage rates having a greater effect on the market.

Sources: Bloomberg, JP Morgan, Morgan Stanley, JP Morgan Securitized Products Weekly

Asset-Backed Securities

ABS have seen choppy execution in the secondary market, and new issue spreads were widened out to bring in demand. Headlines from Greece and China have put investors in a wait-and-see mode. The new issue calendar will be heavy in the coming weeks and will be a good indicator of where the market goes given the changing macro environment.

Sources: Bloomberg, JP Morgan, Morgan Stanley, JP Morgan Securitized Products Weekly
Weekly Commentary: Greece in the Abyss
Week Ending July 10, 2015 - 6

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