Weekly Market Commentary

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Banking on the Greek Election

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

Markets are focused on the June 17 Greek election with poll results holding market-moving significance given what is at stake.

A vote in favor of the pro-bailout parties may provide a relief rally, but bank deposits are already fleeing banks of southern European countries for the safety of Germany setting the stage for a potential crisis if the vote turns out as it did on May 6.

In the meantime, for the markets Greece's polls are like greased polls—hard to grab on to and harder to climb on.

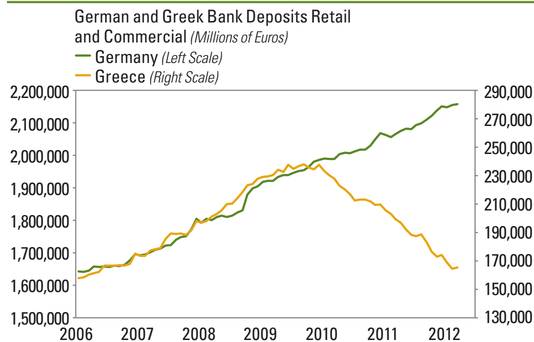
The stock market has been relatively unchanged in recent days, despite some sizable intraday swings. The movements suggest that the market is nervously awaiting a decision to be reached.

This is a big year for decisions. Another important vote takes place this week in Europe with Ireland, a country that received a bailout in 2010, holding a referendum on the European Union fiscal compact. This is a necessary step toward the end-game of Eurobonds and a collective monetary, fiscal, and debt policy for all of Europe. The recent polls in Ireland suggest it is expected to pass. A failure—or even a very close vote—may be viewed negatively by the markets. But this is not why the markets appear to be impatiently holding their breath. Instead, the vote that markets are most focused on at the moment is the June 17 Greek election. This is evidenced by the recent outsized reactions in the stock market to public polling results printed in Greek newspapers.

If the Greek election favors pro-bailout parties with enough votes to form a coalition and avoid the potential for an immediate Greek default, then investors may enjoy a potential relief rally as immediate risks subside. Progress towards a long-term solution for a combined Europe can continue while Greece, a very small part of the Eurozone economy, will remain in a depression.

However, if the outcome of the election is similar to the last one and fails to produce backing for the bailout agreement, the markets will likely continue to slide as a chain of events begins to unfold that holds the risk of a financial crisis.

1 Bank Deposits Leaving Greece for Germany



Source: LPL Financial, Bloomberg Data 05/29/12

Potential Post-Election Chain of Events

The series of events following the election if the anti-austerity parties garner enough votes to endanger Greece's membership in the Eurozone may begin with an acceleration of large withdrawals of euros from Greek banks for fear of a forced conversion to a "new" drachma at a substantially devalued level. Nearly one-third of deposits have already left Greek banks over the past three years as the risk has risen. Interestingly, the Greeks voted against German influence for their economy, but want German protection for their money as Greek bank deposits flee to German banks. Greek banks have seen outflows of 70 billion euros, while at the same time, German banks have seen deposits grow by 200 billion euros as depositors around the Eurozone seek safety. This flow is already accelerating but could become a flood.

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2 Bank Deposits Now Beginning to Leave Spain

Source: LPL Financial, Bloomberg Data 05/29/12

Next in line may be banks in other southern European countries. With the precedent set that countries could leave the euro at the behest of Germany, deposits may leave Spanish and Italian banks, which so far have only seen a small move.

This could then be followed by panic with banks closing their doors for "bank holidays" to halt the runs. The European Central Bank would likely have to inject massive amounts of capital to keep the banks from collapsing.

If the chain of events has not been broken by this point, the next link in the chain is for the troubled banks—most likely to be in Spain and Italy—to be forced to sell their holdings of government bonds in order to meet the outflow of deposits. This could result in losses on these bonds and push yields up even further than the 6% they are hovering around now. If these yields go high enough, other countries such as Spain may be in danger of default with devastating consequences.

This potential series of events leading to a crisis can be avoided, but it increasingly cannot be simply deferred. Europe has been circling around the potential for crisis for three years, sometimes drawing closer, sometimes moving further away, but unable to break free of its pull. The actions of policymakers have been varied and involved multiple bailout agreements and partial defaults that restructured debt obligations. But after exhausting a number of options, potential actions are now limited by the ability of Germany and Greece to come to terms and the willingness of depositors to tolerate any more uncertainty. With the most recent Greek polls supporting the idea that Greece will adopt a pro-bailout coalition government and given the amount at stake, the parties will likely come to an agreement. The outcome is anything but certain.

In the meantime, for the markets Greece's polls are like greased polls—hard to grab on to and harder to climb on. ■

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