Northern Trust | Jim McDonald: Is It Time for a New Grecian Formula?

Is it time for a new Grecian formula? Markets have been seesawing around the latest development surrounding Greece. The old Grecian formula was struck by politicians subsequently voted out of office, while the new Grecian formula likely requires yet another new government. So what is the current state of play, and what does all of this mean for investors?

What is the current state of negotiations? Late Friday evening, Greek Prime Minister, Tsipras, threw in the towel on negotiations, calling for a nationwide Greek referendum on July 5. As the current bailout program expires at the end of June, this has created significant uncertainty about what the Greek people will actually be voting on.

With the European Central Bank camping its liquidity program, the Greek government has had to announce a bank holiday. What originally looked to be hardball negotiating by the Greek government is increasingly looking like an inability or unwillingness to strike a deal.

Why have negotiations fallen apart? When the head of the International Monetary Fund cited a need to restore dialogue with adults in the room, it was a bad omen. There was a lot of speculation that the Greek government was focusing on game theory, resulting in their hardball negotiation tactics.

However, the negotiations only covered a short term solution and did little to address Greece's long term economic challenges. At the end of the day, Prime Minister Tsipras may have just decided that he could not get the package approved by the Greek parliament.

What is the way forward for Greece in the European Union? Greece will struggle with their banking system problems and pulling together a national referendum on short notice. However, the risks from Greece are much lower than five years ago. 80% of Greek debt is now held by the European Union, the European Central Bank, and the International Monetary Fund, reducing the risk to the private sector. For example, European banks have a manageable $33 billion in loans to Greek borrowers while US bank loans total $13 billion.

Polls taken earlier this year showed a majority of Greeks wanted to stay in the European Union. If this then leads to a "yes" vote in the referendum, look for a new government to be formed and negotiations to resume. So what does all this mean for investors? The old Grecian formula included short term deals that just kicked the can down the road. The new Grecian formula should be a long term plan that addresses the unsustainability of Greece's current debt load.

The fallout to risk markets in the current travails includes a rise in peripheral country interest rates and some rise in the European equity risk premium. However, the transfer of risk from private to public sector in recent years significantly mitigates the potential fallout. The primary risk is the small rise in peripheral country yields turns into a large one, but the commitment and firepower of the European Central Bank makes this risk a manageable one.