The possibility of a Greek exit from the eurozone could drive volatility in the coming weeks.

Investment markets around the world have grown increasingly volatile recently as Greece has thus far failed to secure help to pay its national debt. On Sunday, July 5, Greek voters chose to reject the fiscal and structural reforms set out by its creditors as conditions for additional aid. European leaders have said that Greece will need to reach a new deal before the end of the weekend, a move that keeps Greece’s future in the eurozone in question.

“This has become a less predictable situation,” says Dirk Hofschire, CFA®, senior vice president of Asset Allocation Research at Fidelity. “That uncertainty has led to volatility and there is likely more to come as this situation plays out.”

The Greek government had been negotiating a new agreement that would deliver financial assistance to help the country pay its debts in exchange for fiscal and structural reforms. However, the country has not able to reach an agreement with the International Monetary Fund (IMF), European Commission (EC), and European Central Bank (ECB)—known as the Troika.

The Greek government called for the Sunday vote, encouraging Greek voters to reject the Troika’s proposal, while closing the nation’s banks and implementing capital controls. Earlier in the week, Greece had missed a scheduled payment to the IMF, putting it into arrears.

The vote against the Troika proposal makes it somewhat more likely that Greece will leave the eurozone, but that is still uncertain. A new round of negotiations could change the dynamic and it is possible that Greece could default without leaving the eurozone. No country has ever exited the eurozone—it would be an unprecedented step with no clear rules.

No one knows exactly what will happen, but long-term investors should try to keep things in perspective. Here are some insights from Fidelity experts.
Three key questions:
Jurrien Timmer, director of global macro

1. Does the vote mean that Greece will leave the eurozone?

While the risk of a Greek exit has risen, I think it remains a low-probability scenario. The people voted, and government now has a mandate to reject the last offer from the Troika, and now the Greek government has requested additional assistance under new terms. No one wants Greece to leave the eurozone—not the majority of Greek politicians, not the Germans, and, according to one recent survey, not the Greek people.1

Leaving the eurozone could set off a chain of events that questions the permanency of the eurozone’s existence and the membership of the participating nations. This would increase the risk premium that investors would attach to some other European countries, causing issues for those countries and the eurozone as a whole. The way to overcome these concerns is through additional fiscal coordination—increasing federalization of monetary policy—but that may be too extreme a solution for the current constitution and members. To avoid having to broach that, they want to avoid a Greek exit. So I think that, eventually, cooler heads will prevail and come to an 11th-hour agreement on aid that keeps Greece in the eurozone.

2. Could missed Greek debt payments cause ripple effects?

From an investor’s perspective, the big question is whether the events in Greece could be systemic—in other words, whether a Greek default or exit from the eurozone could cause a crisis in the global banking system or affect the fundamentals in Europe or the United States. Even with increasing uncertainty about the direction of Greece, I think the answer is no.

When this problem flared up in 2011 and 2012, the risk was systemic, because banking systems and sovereign governments in Europe were already on shaky ground in the wake of the financial crisis. At that time, many banks and sovereigns were dealing with bad assets on their balance sheets. European banks, private sector investors, and pensions owned Greek debt, and would have taken losses in the event of a default, which could have limited the banks’ ability to lend, and led to a financial crisis.

But since 2012, more than 80% of Greece’s sovereign debt has been moved to the IMF, ECB, and Europe’s first bailout fund, the European Financial Stability Facility. So even in the event of default, banks won’t take losses and capital ratios will not be affected directly by Greece, allowing banks to keep lending.

The other important removal of systemic risk is the ECB’s bond-buying program and emergency liquidity assistance available to European banks. This greatly reduces the risk of contagion to peripheral European countries.

3. What should investors keep in mind?

Ultimately, the uncertainty regarding Greece could drag on for weeks, and that could create volatility in the bond, stock, and currency markets. But there are important firewalls in place to limit the impact of events in Greece from spreading to other markets. So it is important to take the long view here and avoid being whipsawed by short-term events.
Positive economic trajectory largely intact:

Dirk Hofschire, senior vice president of Asset Allocation Research

The vote on July 5 marked an important moment in the evolution of the Greek debt crisis, but the next step is not clear. In some ways, the vote just crystallizes further the heart of the disagreement—Greece wants further financial assistance with less austerity, while its creditors demand a sustainable fiscal program as the condition for aid. The vote essentially clarified the Greek population’s support for the government’s position, but if Greece is to remain in the eurozone, there still needs to be a compromise on the terms of conditionality for further financial support.

Whatever the next step, it is very unlikely that the situation is going to be resolved quickly or cleanly. As a result, we are in a period of uncertainty that may not clear up for weeks.

The good news is that this may have a much more limited impact on Europe and global financial markets than it might have had three or five years ago. The ECB has liquidity programs and other tools available to help soothe markets during this period of tumult, and the eurozone economy is much better now than at any point since the financial crisis.

During a similar crisis a few years ago, yields on 10-year sovereign bonds in the periphery of Europe rose above 7% in Spain, Italy, and Portugal. Today, those bonds have yields around or below 3%, and they haven’t spiked even as Greece’s bond yields have risen dramatically. This is an indication that investors have much more confidence in the ECB and policymakers, the improved economic position of Europe, and the more limited exposure of Europe to Greek bonds, loans, and other assets. The markets clearly don’t think that the eurozone is on the verge of dissolving, so there is much less risk of contagion.

The bad news is that this crisis has introduced a huge amount of uncertainty—just when Europe’s economy was gaining significant traction. Even though Greece’s leaving the eurozone would not be devastating and wouldn’t mean another European financial crisis, volatility and uncertainty can bleed back into business confidence and could stall some of the economic progress we had expected. The riskier areas of the asset markets, such as stocks, are clearly getting hit near term due to increased investor uncertainty. Still, I feel confident that the European business cycle can eventually get better and provide a reasonably attractive backdrop for investors over the next 12 to 18 months.

In the United States, the economic outlook is even less dependent on the outcome in Greece. The biggest and best-performing part of the U.S. economy is the domestic side, which is benefiting from improvements in employment and healthier consumer spending. If you think about the parts of the U.S. economy that are not doing so well—exports, manufacturing, investments in energy, and multinationals—all are being held back by the stronger dollar and weak global growth. Greece is a complicating factor in a global environment that was already not helpful to the U.S.—an environment consistent with our expectation that investors should expect more volatility as the year goes along. However, Greece should not change the overall outlook for the U.S., which I still believe should continue to be in a mid-cycle expansion, which favors risk assets, including stocks.
The information presented above reflects the opinions of Jurrien Timmer, director of global macro, and Dirk Hofschire, senior vice president of Asset Allocation Research, as of July 6, 2015. These opinions do not necessarily represent the views of Fidelity or any other person in the Fidelity organization and are subject to change at any time based on market or other conditions. Fidelity disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions for a Fidelity fund are based on numerous factors, may not be relied on as an indication of trading intent on behalf of any Fidelity fund.

Investing involves risk, including risk of loss.

1. A survey by pollster GPO published Monday, June 15 said that nearly 70% of Greeks want to stay in the euro even if it means more austerity, as reported by the Wall Street Journal, “Greeks Brace for More Economic Pain, Bailout Deal or No,” on June 17, 2015.

Past performance is no guarantee of future results.