Overheated Financial Planet, World Political Chaos and Shadow Banking

World political chaos, statistical "smog", Risk that the Financial Planet Explodes... But Solutions for the Future Continue to Emerge

By Global Europe Anticipation Bulletin
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Historians, who usually consider that the 19th century runs from 1815 (Waterloo) to 1914 (the First World War) would certainly define the 20th century by the period 1914-2014, ending with the year in which the old system dies whilst a new one emerges. In this New Year 2014 welcome, then, to the 21st century!

We have symbolised 2013 as "the first steps in a chaotic world after" (1).

A year which was in effect the new century's zero year and at the end of which solutions were emerging from all sides. At the beginning of 2014 the spotlight is henceforth on the Eurozone, China, Russia and the BRICS where the tools to shape the "world afterwards" are being designed with incredible rapidity: the "world before" is handing over to "the world afterwards".

Nevertheless, there is a permanent risk of an explosion from the overheated financial planet driven by the incredible US imbalances… unresolved or little resolved.

And the current transition period, certainly hopeful, is highly dangerous nevertheless. One danger is the statistical "smog" (2) which will probably characterise the year: first, the US economic and financial indices have lost any sense of direction by dint of being manipulated in order to hide the catastrophic reality; and second, the emerging world's tools of statistical transparency aren't sufficiently reliable to properly throw light on the reality. A collapse of visibility ongoing for several years on the one hand, the beginning of an organised transparency which the world economy needs to plan strategies on the other, in 2014 we are on statistical understanding's trough of the wave. And that won't be without its consequences.

STATISTICAL « SMOG »

The current period is particularly difficult to analyse. Central bank liquidity injections have hardly any historical equivalent and act insidiously like morphine; the stock exchanges move inversely proportional to countries health; finance and derivatives are completely out of control; the West and the US in particular are trying to hide their disastrous situation through benchmark signals which no longer say anything (like the unemployment numbers)… We have already analysed this "statistical fog" in the GEAB N° 73: the old world's compasses are broken.

Markets bottle-fed by the Fed and not wanting to abandon the Dollar paradigm as long as there is any blood left to suck is largely responsible for this blindness. But just as the frog in boiling water doesn't feel the temperature rise until it's too late, having broken the thermometer is certainly convenient for maintaining the illusion but raises a suicidal trend: if the exit is already difficult to find in broad daylight, it will be impossible in the dark. As we have already said, the Eurozone has been fortunate to have been in full daylight for several years thanks to the "Euro crisis" and isn't hiding its difficulties with a lorry load of liquidity (3), luck which isn't benefiting the United States which is going blindfold to the precipice as we will see.

Change in major central bank balance sheets since August 2008, in percent. Source : Merk Investments

At the moment, one eye is blind and, sadly, the other can't yet see. That part of the world which has emerged, the BRICS especially and China in particular, have only just started to build a statistical apparatus adapted to their international ambitions. Moreover, a number of Western addictions have been adopted by these countries, like the use of debt and deregulated finance, which pose new dangers. Thus China has begun to concern itself with its local government indebtedness, its "local government financing vehicles" (4) and its "shadow banking" of which no one has any idea of the size absent any reliable statistics (5).

This shadow banking is both essential to finance small businesses and local communities and is uncontrollable at the moment… Hence Beijing's acceleration to clearly see and get to regulate this sector, evidenced by the recent statistical work carried out here by the National Audit Office, where greater transparency has been demanded from Chinese banks, or as another example, the five-year prohibition on local authorities to build new government buildings with "shadow" financing (6). But despite these efforts at transparency which will quickly bear fruit, because the international situation needs a clear view, a few more years are necessary to have a reliable statistical apparatus in this country. Without counting that the Chinese government still needs areas of shadow for some time yet: one can't switch on the lights without first having done the housework!

So, it's with great caution that leaders must advance along a difficult path along which the absence of reliable indices prevents a proper understanding of the situation. Any anticipation/forecast/planning is, of course, much more difficult. However, if the emerging countries have extremely powerful dynamics that allow them some differences, mistakes can lead to dramatic consequences for the others. That's why the Fed is doing a remarkable balancing job and up until now this tightrope walker has been talented enough to keep the country on the wire… so long as there is still a wire.

THE RISE IN INTEREST RATES AND THE COLLAPSE OF US REAL ESTATE

Meanwhile, the century which is ending continues its slow death. Despite all the Fed's actions, despite its huge programme of quantitative easing, US bond interest rates are rising inexorably. We will detail the reasons in the Telescope section and show that this trend will continue in 2014.

US 10 year Treasury bond interest rate (in %), June 2012-January 2014. Source : MarketWatch

But a 1% interest rate rise on the 10 year note (from 3% to 4%) means a steady increase in the annual interest rate payments on the US debt in the order of $100 billion to $150 billion (7), nearly 1% of the public debt to offset whilst the Fed has begun to reduce its bond repurchase programme. But this isn't the most painful. The following chart indicates something much more dangerous.

30-year mortgage rates, 2012-2013. Source : FRED.

The continued rise in US bond interest rates actually causes a similar increase in individuals' borrowing rates. In 2012, 30 year mortgage rates were around 3.5%; now they are around 4.5%; a further one percentage point increase would therefore bring them to 5.5%. Yet at 3.5% a household could borrow $400,000 with monthly repayments of $1800, whilst at 5.5% it could borrow no more than $317,000 with the same monthly repayments: therefore it would need around a 20% fall in real estate prices (!) to keep the same purchasing power… As we have already seen in the GEAB N° 80, concern on this subject is becoming obvious (8) and 2014 will see a significant fall in US real estate prices as we will explain further in the Telescope section. Yet all the real estate finance works only on the assumption of rising prices (compare with 2007-2008); in addition, a huge number of Americans' consumer loans are pledged on their houses and real estate market weakness would, therefore, spread throughout the economy. This is the really bad news of this beginning of year.
Notes:

1 Title of the GEAB n°70 (December 2012).

2 «Smog» describes the mixture of smoke and fog which regularly covered London during the Industrial Revolution.

3 This largely explains the lower growth. In the US, official growth in 2013 was only around $400 billion (around 2.5% of GDP) whilst the Fed injected more than $1 trillion into the economy… A "loss" of $600 billion. During the same period, the ECB withdrew around $1 trillion (€730 billion, source ECB) for almost no growth, a "gain" of $1 trillion. Who is in poor health? Look at the following chart as well.

4 Source : Ecns.ch, 08/01/2014

5 On this subject and what follows read Les Échos (10/01/2014), Bloomberg (09/01/2014).

6 Source : La Croix, 30/07/2013.

7 Evaluated from Wikpédia taking into account the distribution of US debt according to maturity.

8 See also the worrying article in MarketWatch (14/01/2014).

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