

Grand Delusion Update by Cliff Wachtel

The rising demand (and falling yields) for the Global Investment Performance Standards's sovereign and bank debt despite the sad fact that default risks have increased, not decreased.

The past week brought further increases in both GIIPS asset prices AND their risks. That's not supposed to happen.

Based on its outlook for the coming years, the EURUSD should not be in an 18+ month uptrend and sitting in the middle of its trading range of the past 5.5 years.

It fails to successfully meet any the commonly accepted four basic criteria of an optimal monetary union first described by economist Robert Mundell and so theoretically shouldn't succeed. Nothing in the EZ's experience thus far disproves him.

Risks are getting worse, the EU has not only failed in its first real attempt to actually heal itself, the SRM banking deal actually made another banking crisis more likely than ever.

Meanwhile its own banks are slowly strangling it, or threatening it with a new crisis.

In recent weeks, GIIPS assets have risen even as their risks did too. The EURUSD's (Euro/US dollar exchange rate) uptrend since July 2012 remains intact, even with bouts of weakness in the past months.

Why is the EURUSD NOT plunging?

The key reasons include:

The anticipated increased interest rate advantage for the USD over the EUR has not yet happened

The Fed balance sheet continues to expand while the ECB's does not.

Although leading global stock indexes have slowed or halted their rallies, they haven't pulled back as a group, which also helps the EUR. There's a bit more to it than that.

Germany's real (price-adjusted) GDP growth slowed from 0.7% in 2012 to 0.4% in 2013, below the consensus estimate of 0.5%. Germany's Federal Statistical

Office attributed the drop to the continued falling demand in Europe outweighing robust gains in domestic demand. A drop in Germany's trade balance cut GDP by 0.3%, suggesting that Germany isn't overly reliant on exports (via seekingalpha.com's market currents).

Lessons worth noting include:

The strongest economy in the EU has a growth rate that would be a clear harbinger of recession in the US, where GDP growth of less than 2% is considered to mean that the economy is about to tip into recession.

Therefore remember that Germany's status as the growth engine of Europe is somewhat relative, and that it is unlikely to be in any mood for large scale handouts that its neighbors would like.

In China, a new political order brings pro-market reforms, unleashing a wave of growth, a robust economy, and a strengthening currency used by such a huge chunk of the world's population that many predict it could soon replace the US dollar as the global reserve currency.

Alas, the good times were fueled by too much debt too willingly provided and taken because real estate/stocks/whatever are only going higher,.

Then, a seemingly small, isolated default suddenly casts doubt on the solvency of any bank or government that might be exposed to losses from that default. No one knows who is solvent and who isn't and suddenly the one default metastasizes into a systemic banking crisis and credit freeze that threatens recession or even depression for the entire region if not the world. Markets aren't thrilled, and promptly nosedive.

First the US, (or was it Japan?) then Europe, now China? China has already hit steps 1 and 2, and is now trying to avoid #3.

The story isn't really new; mainland Chinese investors (versus the more overseas oriented Hong Kong index) have known trouble was brewing for over a year.

However, like those of the US and Europe, it takes time before it starts getting global attention.

Last week things China edged a bit closer to step #3

It reported continued declines in lending and money supply growth.

We're hearing reports of increasing default risk for many of China's wealth management products (WMPs). Unfortunately, these are roughly like the infamous collateralized debt obligations (CDOs) that helped ignite the subprime crisis and ultimately the GFC. Like the CDOs, these are packages of securities, some with low credit risk, and some with high default risk. Unfortunately no one is sure where the risk is hidden and who owns it. Unfortunately the WMPs are widely held throughout the financial system.

So guess what happens if these WMPs start to default?

Is this starting to sound familiar?

Unfortunately, there is real risk of a wave of WMP defaults.