

US ECONOMY 3rd QUARTER REPORT.

The FAANG group of corporations reduced to the NA group.

It was Marx who first observed that history repeats itself first as tragedy and then as farce. The same can be said of the US economy. Under Reagan's daft fiscal policies, the US economy wilted. But the US economy was saved by a tragedy, the vast export of jobs to Asia lubricated by technical developments such as the internet. Trump with his farcical December tax giveaway to the corporations has again introduced daft fiscal policies that will undermine the US economy. Now that the euphoria of the tax give-away party has ended, the bill for paying for it has been presented in the form of higher interest rates. The difference between now and then is that Trump represents the end of an era while Reagan marked its beginning, which means that unlike the early 1980s, the US economy is now boxed in.

In line with the previous report, this posting consists of two parts, an analytic report on the economy up to the 3rd quarter and secondly, a look at current developments in the world economy. Unlike the previous report which waited upon the BEA to release fourth quarter corporate profits, this report is posted before this release. The reason for this is the tax code will muddy the picture for corporate profits until after the first quarter of 2018.

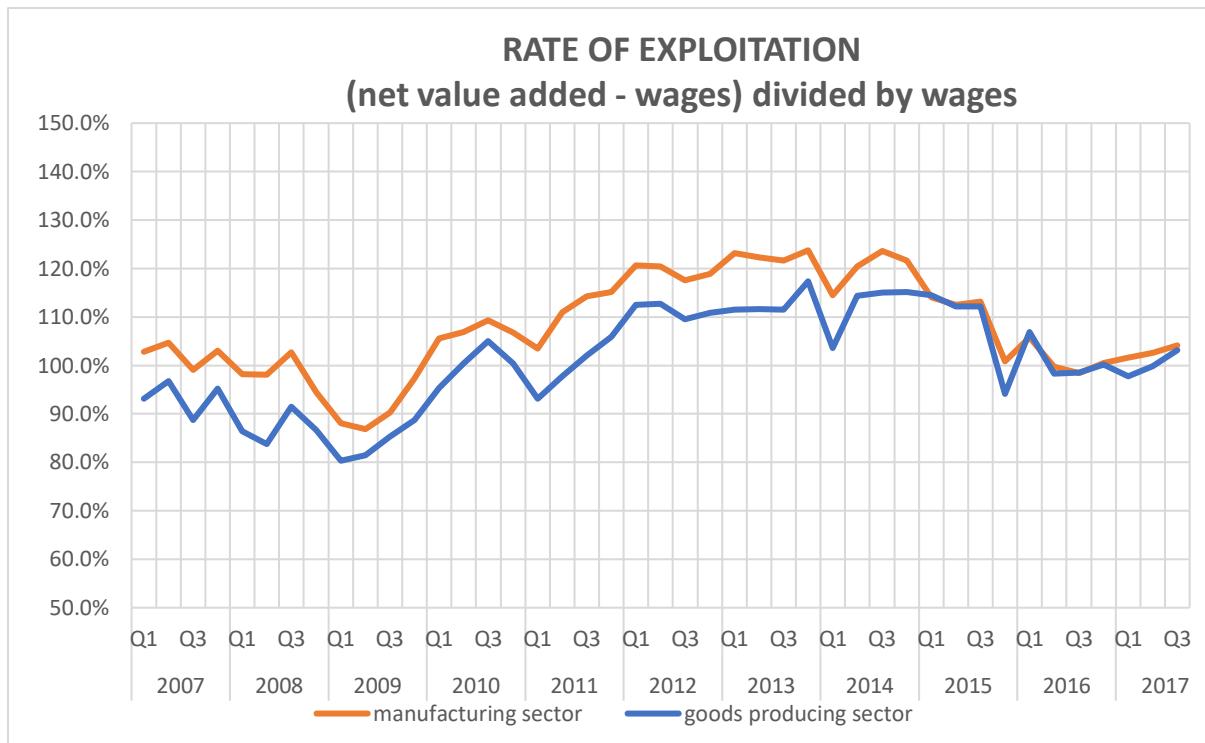
Corporations are and will use this new tax code to massage their profits behind the veil it has thrown up. What is of great interest, is the way the new tax code has exposed the huge stash of tax losses these corporations were carrying on their books nearly 10 years after the financial crash of 2008. This has been helping them reduce their tax bills gradually year by year. In the last quarter, even before the new tax code took hold, and, despite an improvement in profits, total corporate taxes fell by \$10 billion because the legacy of tax credits allowed corporations to profit from their losses. (<https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53443-mbr.pdf>)

The other feature that clouds the profit picture for non-financial corporate profits is the prevalence of financial profits contaminating industrial profits. This is typical of periods when markets are frothy allowing fictitious profits to percolate throughout the economy. A better reflection of corporate profits will take place in the first quarter of 2018, if as expected, share and bond prices now go into reverse wiping out fictitious profits.

Part 1. Third quarter rates of exploitation, turnover and surplus value.

The third quarter (2017) rate of exploitation increased significantly. Exploitation is arrived at by deducting wages and salaries from net value added to yield the gross surplus. This surplus is then divided by wages and salaries to obtain the rate of exploitation. This is the crude rate of exploitation because ideally it is compensation (wages plus benefits) that is the important figure, not wages alone, but compensation for the third quarter is not yet available.

Table 1.



Source: BEA Interactive Tables, National Income Tables 2.2B for wages revised 26th January, Table 6.1D for net value added revised 26th January)

Rates of exploitation are similar for both the goods producing sector and the smaller manufacturing sector. Both rates now sit above the levels obtaining before the 2008 crash but below the plateau ending mid-2015. This increase in exploitation is mystifying as it is normally associated with a rise in productivity and a fall in labour costs. However, in the third quarter, as the latest release from the Bureau of Labour Statistics for manufacturing shows, productivity fell sharply in the third quarter by 4.9%, reducing annual growth to just 0.2%, while compensation rose by 0.6%.

Year quarter	Real					
	Labor product- ivity	Output	Hours worked	Hourly compensa- tion (1)	hourly compensa- tion (2)	Unit labor costs
Percent change from previous quarter at annual rate (5)						
2017 ANNUAL	0.7	1.7	1.0	1.6	-0.5	0.9
2017 IV	5.7	7.3	1.5	1.8	-1.8	-3.7
III	-4.9 r	-1.6 r	3.5	0.2	-1.8	5.4 r
II	3.6	2.9	-0.6	2.3	2.6	-1.2
I	0.2	2.3	2.1	4.4	1.2	4.2

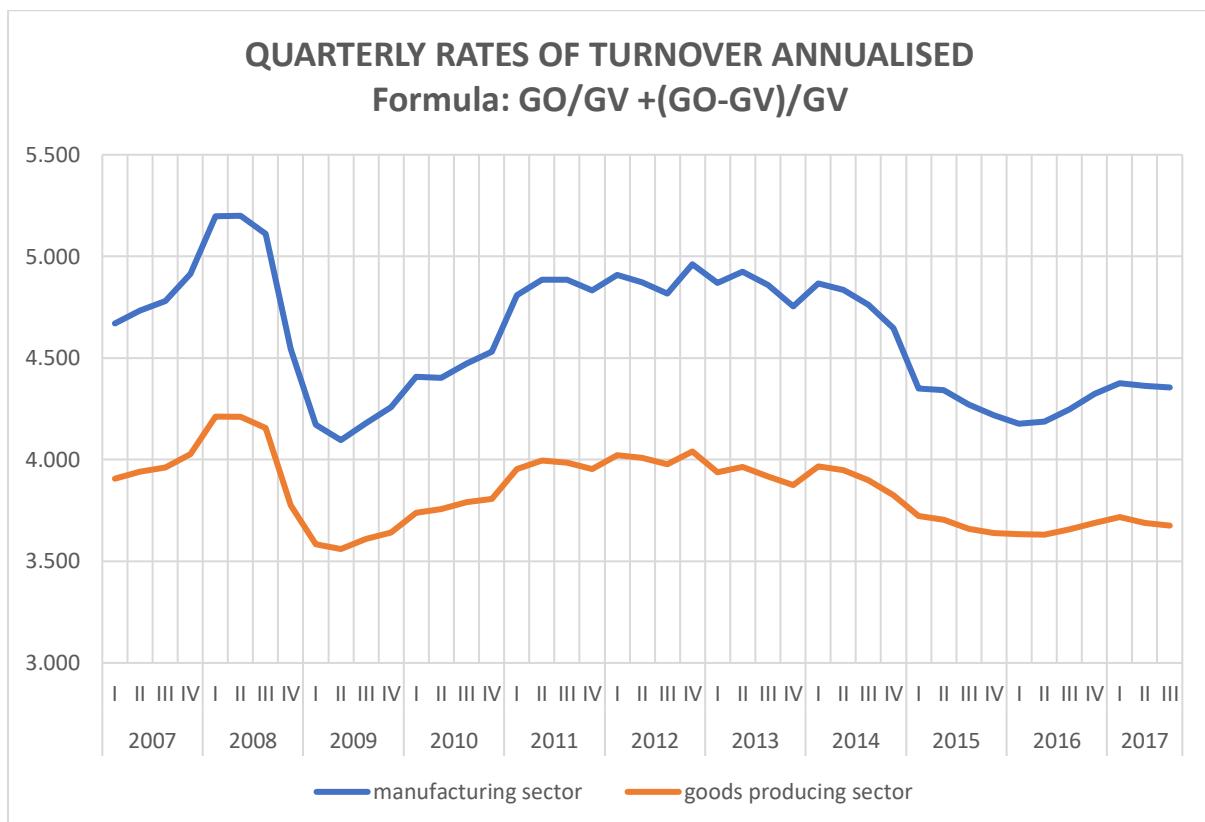
Percent change from corresponding quarter of previous year

2017 ANNUAL	0.7	1.7	1.0	1.6	-0.5	0.9
2017 IV	1.1	2.7	1.6	2.2	0.0	1.1
III	0.2 r	1.3 r	1.2	0.6	-1.3	0.5 r
II	1.3	1.8	0.5	1.2	-0.7	-0.1
I	0.2	0.8	0.6	2.4	-0.2	2.2

(Source: Bureau Of Labor Statistics 1st February 2018)

Weighing on the rate of surplus value, despite the dubious rise in exploitation, was a continued but gentle fall in the rate of turnover. The rate of turnover is well below either the peak achieved in 2008, or 2014, and because of that it restrained the growth in the all-important rate of surplus value.

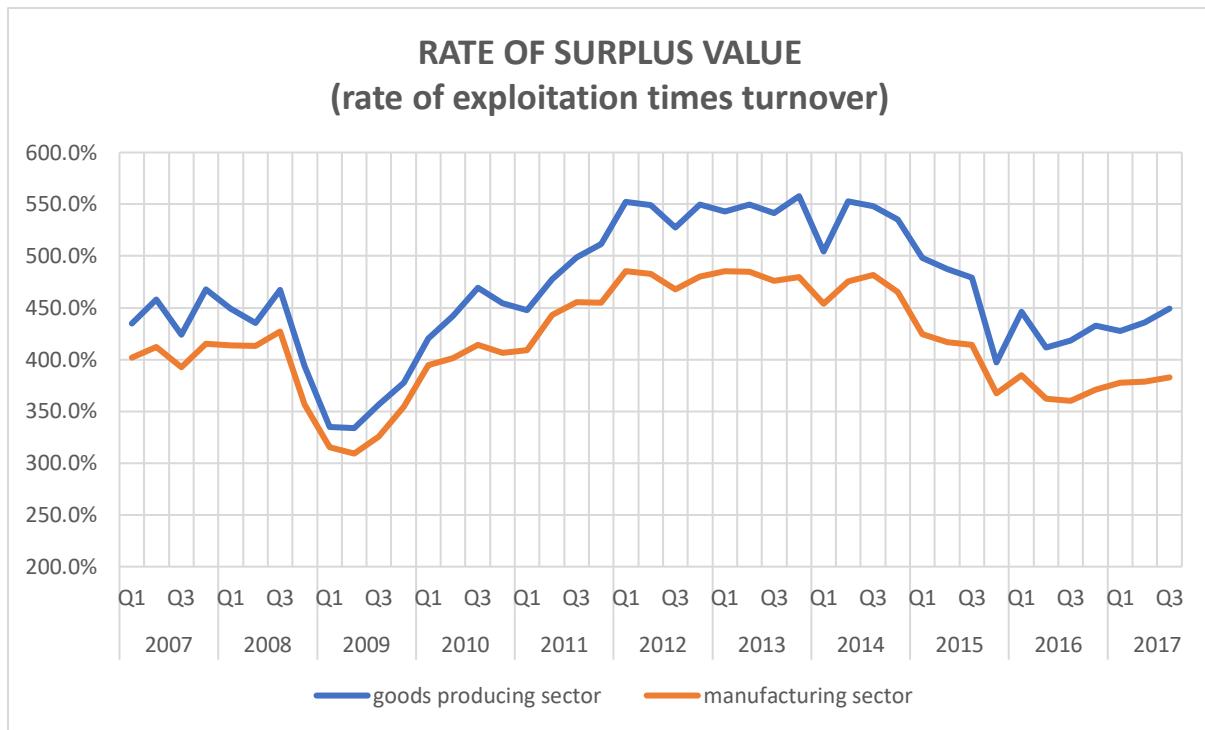
Table 2.



(BEA Interactive Tables, GDP-by-industry Gross Output and Gross Value Added Tables for turnover revised 19th January. Rate of turnover = $GO/GV + (GO-GV)/GV$ where GO = gross output and GV = gross value added.)

The rate of surplus value continued to rise in quarter three as Graph 3 below shows because the increase in exploitation outweighed the deceleration in the rate of surplus value. In the goods producing sector, the rate of surplus value, due to the boost from the oil industry, is approaching the level found prior to the 2008 financial crash of around 450%. The same does not apply to manufacturing. Here the rate of surplus value sits well below its pre-2008 level as well as its 2014 level. In part this is due to China's ascend up the value chain.

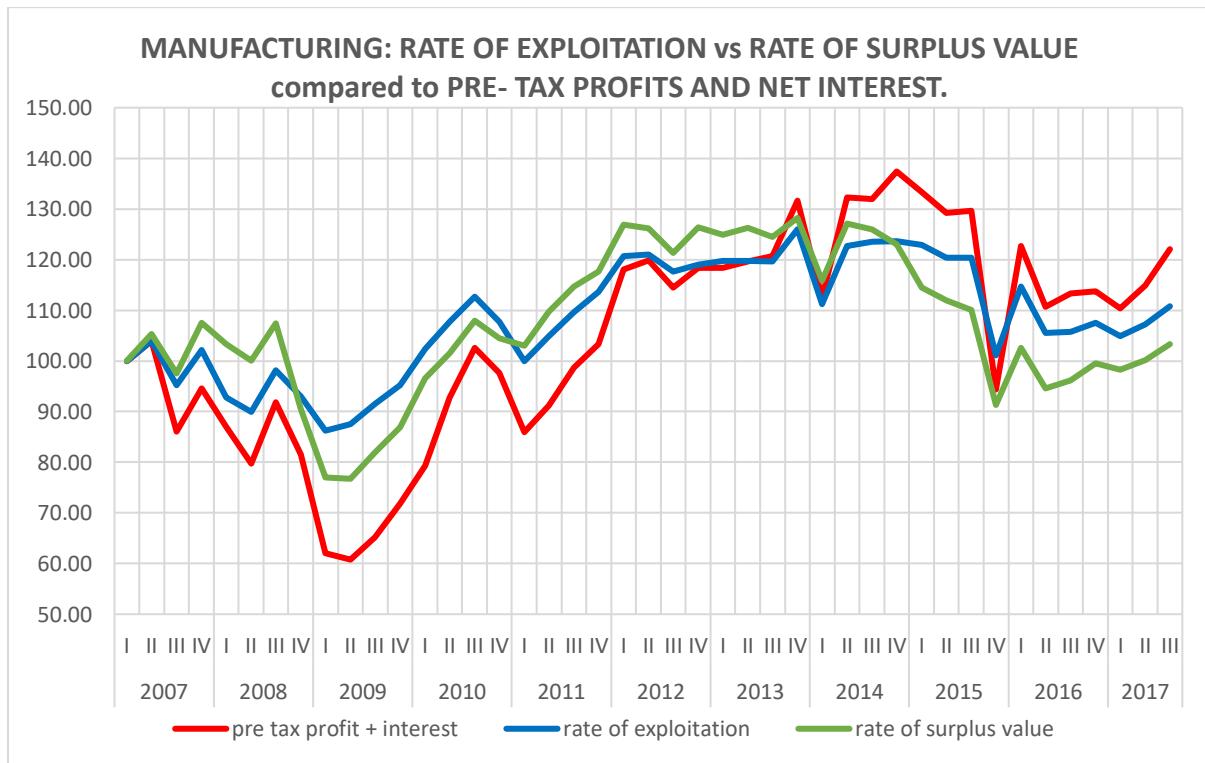
Table 3.



(Source: as above for wages and net value added. BEA Interactive Tables, GDP-by-industry Gross Output and Gross Value Added Tables for turnover revised 19th January)

Having determined the rate of exploitation and surplus value, these rates are compared to the mass of profits and interest in Table 4. To make comparisons easier, all graphs are rebased to 100 in 2007.

Table 4.



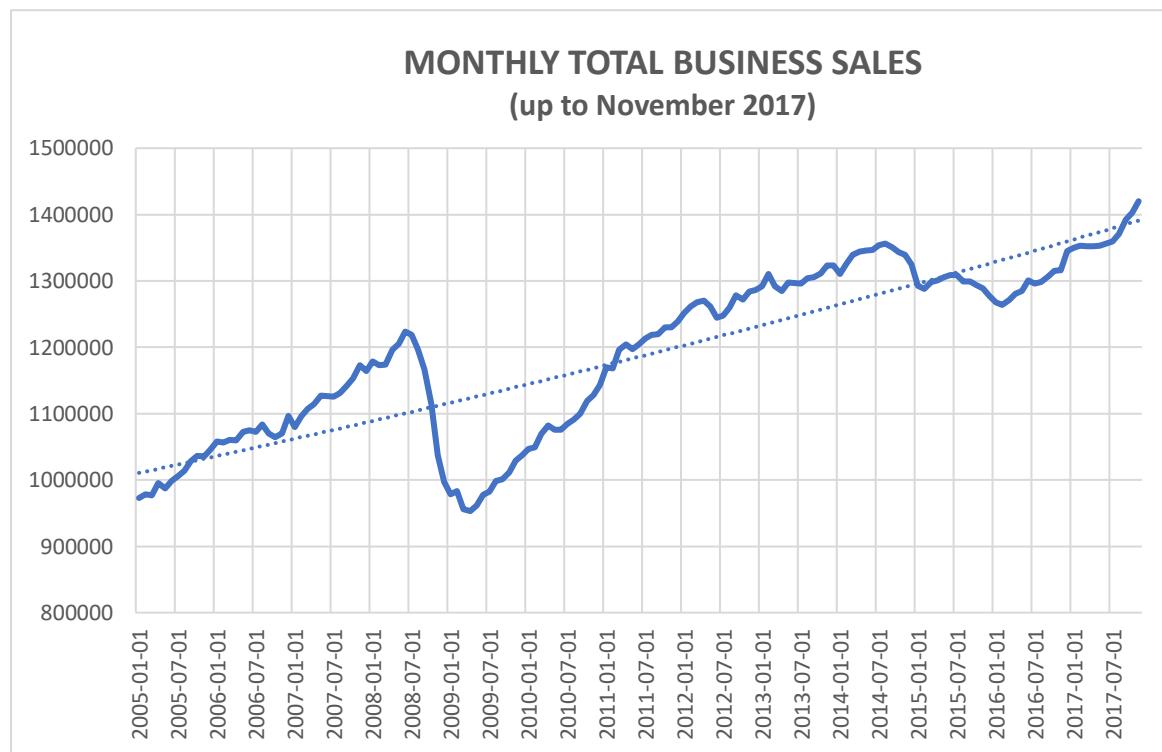
(Source: BEA Interactive Tables National Income. Table 6.16D for pre tax profits and 6.15D, 1.12 for interest)

Throughout 2017 the mass of pre-tax profit and interest increased. The increase has accelerated because both the rate of exploitation and that of surplus value have increased. This year the increase has been 11% in nominal terms, leaving profits and interest 15% below its most recent peak in the fourth quarter of 2014 (measured in inflation adjusted terms). It is also unlikely to beat that figure until such time that the rate of surplus value exceeds the rate of exploitation as it did in the lead up to 2014. Though the gap between the two rates has closed from 10.5% in q2 2016 to 7% in the current period, it will require another 2 years of output growth for the mass of profits to increase beyond 2014 unless the rate of turnover accelerates.

The same is likely to be the case with domestic corporate profits, especially non-financial profits. Despite the improved outlook for profits due to the weak dollar and higher oil prices, the uplift will still be insufficient to achieve the peak reached in 2014 in real terms, while the outlook for 2018 is deteriorating rapidly for reasons which will be discussed later in this posting. Therefore, the economy measured by profitability is still stuck in the phase of rising animation and has not yet entered the period of prosperity when measured purely by comparable profits.

Another way of phasing the economy is to examine Total Business Sales which combines retail, wholesale and manufacturing sales. Collectively they represent over 50% of sales within the US economy. Here the November figure is approaching, in real terms, its preceding peak. Hence in the sphere of circulation, the economy appears to be approaching the prosperity phase. This is consistent with, what was, a booming stock market and sales that replenished the damage wreaked by the hurricane season last year. However, while sales are expected to have risen in December, the reversals on the stock exchange together with higher interest rates and a falling dollar, is bound to disrupt the upward trend.

Table 5.



(U.S. Bureau of the Census, Total Business Sales [TOTBUSSMSA], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/TOTBUSSMSA>, February 5, 2018.)

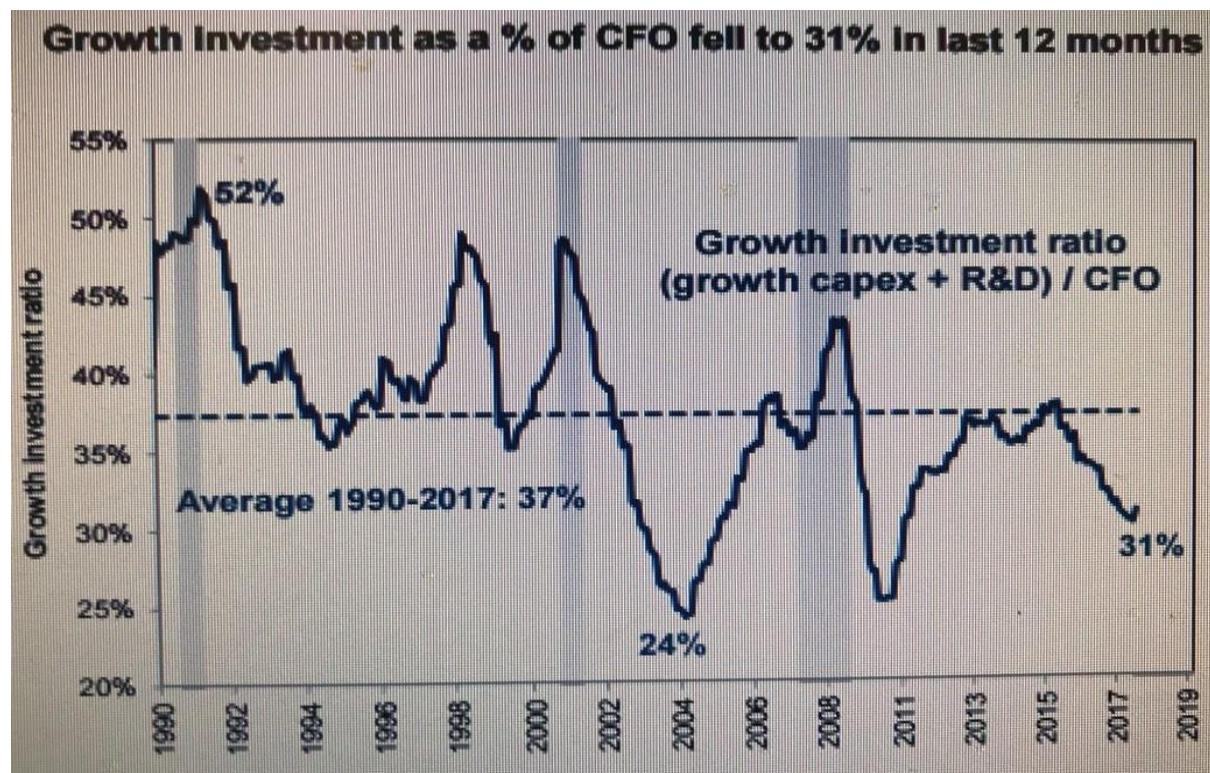
Part 2. The falling dollar.

Friday (02/02/2018) and the following Monday's fall in the stock markets attests to the importance of judging the phase the world economy is in. Up until Friday, analysts were congratulating the markets for their orderly digestion of rising interest rates. But quantitative rises in interest rates pass over dialectically into qualitative rises when given an impetus as happened on Friday when inflation and wage figures were released. (It is interesting that Bloomberg miscalculated the wage rise.)

The movement from a phase or period of rising animation into one of prosperity is generally marked by rising interest rates as the demand for money capital by industrial capital accelerates. Superficially, it appears that the world economy, as indicated by the US economy, has entered into the phase of prosperity. Unemployment is low, inflation is rising and with it wages. Hence price pressure appears to be building up in the spheres of circulating constant capital and variable capital. However, this needs further investigation. Employment figures in the USA are dubious at best. Wage pressure is driven mainly by housing and health costs both of which are highly financialised. Finally, the uptick in raw material prices owes more to the deliberate restriction of supply, especially by China, than it has to do with robust demand. For example, the Baltic Dry Index, despite the shortage of new vessels, is down sharply from its 2017 high. Looking at the matter quantitatively, the three key global commodities - residential housing, cars and smartphones – are all showing decelerating sales not accelerating sales.

The evidence simply does not support the case that rising interest rates are being caused by the demand for money capital by industry for the purposes of expanded investment. As the graph below shows, investment as a share of corporate cash flow has been falling not rising in the USA. Most new loans are being used to roll-over, replace or add to existing borrowings, meaning that this money-capital is returned by industry in the form of repayments or additional deposits to the banking system.

Graph 6.



<https://theotrade.com/investors-ignore-40-billion-q4-write-offs/>

Rising interest rates in the USA has a more specific and alternate cause and that is the ballooning deficit, aggravated by December's change to the corporate tax code. As has been pointed out already, corporate taxation was falling even before the December tax change. The Congressional Budget Office, projects an additional \$455 billion of borrowing this fiscal year followed by more than a trillion dollars next year. And that was before the stock market correction and renewed volatility undermining growth projections for 2018.

The Republican Party deluded itself, as did Trump, that this additional borrowing would not be needed because of accelerating economic growth. Now that the truth has tripped them up, it is unclear how they are going to raise the debt ceiling, as within the ranks of the GOP are those who are determined to reduce rather than expand the fiscal deficit. Foreign investors on the other hand have not been deluded. They are concerned by the rising budget deficit floating on a sea of debt navigated by a dysfunctional Congress and Senate. The result is a massive withdrawal of foreign investment since the tax bill was passed.

Graph 7 below shows the sharp fall in the dollar despite rising interest rates. This is in part due to the withdrawal of investments by foreign depositors.

Graph 7.



"In total, in November 2017, foreign holders of U.S. Treasuries declined by \$398B, a drop of -6.2%. In terms of total dollar volume, the foreign holding decline in November is the largest ever recorded by far. And in percentage terms, it is also the largest, beating out a similar moment in the 1999 stock market bonanza when over a three-month stretch from October 1999 to December 1999, the decline was \$61.2B each month, a -5.4% drop each month." This explains the paradox of a falling dollar despite higher interest rates, even when adjusted for inflation and other factors. (https://seekingalpha.com/article/4143094-djia-drops-666-points-ominous-signal-stock-market?auth_param=1en7tk:1d7gpns:591eaf76377a9dab9362923b6af18460&uprof=46&dr=1 by Daniel Moore.) "2018 is off to an even worse start, with the dollar registering its steepest January decline since 1987. In fact, against the Chinese yuan, January was the weakest month for the dollar

since 1994" - https://seekingalpha.com/article/4143678-raising-rates-reflect-bigger-debt-faster-growth?auth_param=1en7tk:1d7k22k:8bdcb331abe54c434cc58d7d6d81120&upref=46&dr=1

This withdrawal of capital involved all the major countries and included sovereign entities as well as private individuals. Clearly these countries have lost confidence in the US economy and were putting their countries first. And they should. The US is run by a foolish president heading an incompetent party. Together they are driving the economy into the swamp.

The tax giveaway to the rich in December was unaffordable. It was unaffordable for two reasons, firstly its effect on interest rates and secondly its impact on public debt. I have argued extensively that the US economy cannot withstand interest rates above 2.7% (10-year bond) at current levels of inflation. Wall Street analysts project 3.5% as the trigger point which is far too high. The figure of 2.7% is confirmed, *inter alia*, by the recent behaviour of house-builder shares against a background of interest rates trending towards 2.7%. They have suffered their longest losing streak since 2002 and the pain is only beginning.

The US economy is driven by consumption and not investment. It is precariously balanced and unhealthy. Consumption is driven by two factors. The previously rising stock markets and cheap money (low interest rates). What makes this period unique and therefore incomparable to previous periods is the following: (a) Inequality tends to lead to elevated asset prices because of its effect on interest rates and because of the availability of funds for speculation. Hence elevated share prices are the new normal and P/E metrics are not strictly comparable to previous periods when inequality was not so elevated. (b) This phenomenon is of course contradictory. It also amplifies the effect on the real economy from the price movements of these elevated "assets" (really bets on assets). It is a form of perverse leverage. Today the top 5%, the main body of investors, consume (unproductively) as much as the bottom 90% of society. Consumption thus depends on the behaviour of the top 5% whose behaviour in turn is moderated by share and bond price movements. Any fall in share or bond prices which makes them feel "poorer" therefore has a disproportionate effect on spending in the economy. It can be said alternatively, that the well-being of the economy now depends on the presence of bubbles in asset values.

(c) This is where the importance of interest rates comes in. Shortly after Trump was inaugurated, 10-year bonds reached 2.63% (in inflation adjusted terms similar to the 2.8% today). This had an immediate dampening effect on the economy, particularly consumption, which fell back. As if by reflex, interest rates fell back sharply and by September the 10-year was down to 2.04%. This time round, such a retreat has been cut off by sharply rising US government borrowing due to the new tax code and foreign withdrawals of investment.

The result will be a sharp contraction in demand. While it may be the case that US stock markets will reverse much of their recent losses over the next few days, asset prices have suffered a flesh wound and the bullet has not been extracted. The real reversal in the stock markets will come in the months ahead, not because algorithms have become unrulier, but because the realisation will dawn that the "buoyant" underlying economic conditions have been undermined by higher interest rates.

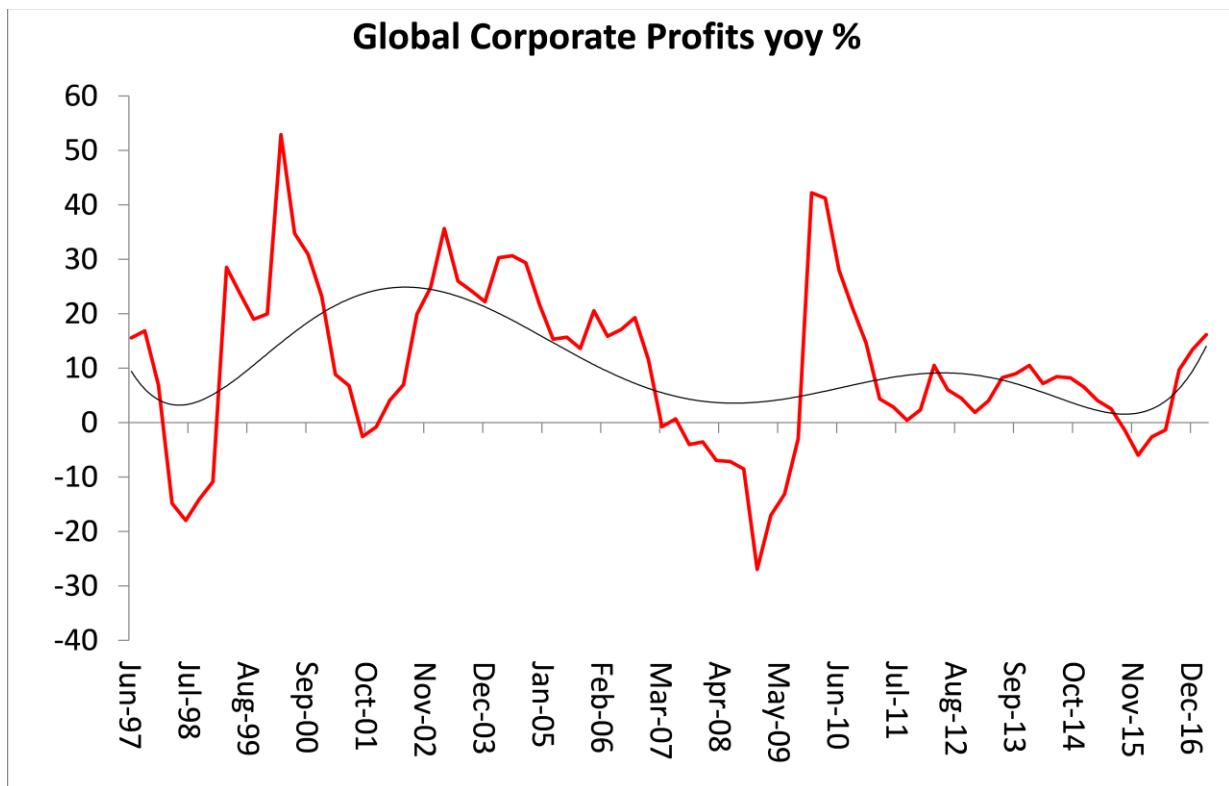
The impact on the economy of higher interest rates will eclipse the benefits to the corporations of a reduced tax bill. After all, corporations have to earn profits before these profits can be taxed. As for Trump's much vaunted infrastructure programme, that is as solid as most bridges in the USA. If anything, the opposite is the case, Congress will force spending cuts to try and reduce the deficit.

In the round, what is taking place is the end game for neo-liberalism, the final consequences of growing inequality. A bankrupt state, a capitalist class ruined by speculation and society mired in immiseration. An ignoble end to history's first industrial society.

Conclusion. The question of profitability.

The current period is marked by rising real profits. The final graph below, is taken from Michael Robert's blog: *Stock Market Crash: 1987, 2007 or 1937* which shows a rise in global profits. Although not comparable to the rises obtaining before the 2000 and 2008 crash, they have accelerated over the last 6 months. And as Mr Roberts has pointed out, unlike 2000 and 2008 there is no preceding fall in profits before these two market crashes.

Graph 8.



There can be no doubt that there has been an increase in the mass of profits since the mini-recession at the end of 2015. What is questionable is the quality of some of this growth especially in China. In addition, the growth in profitability is concentrated in raw materials, especially oil and its products.

The growth in profits is a function of increases in output multiplied by either an increase in the relative or an increase in the absolute rates of exploitation adjusted for changes in turnover. It can be argued that the current growth in global wages blocks the growth in the absolute rate of exploitation unless inflation is grossly understated. This leaves the increase in the relative rate of exploitation as the main determinant. This implies workers producing more for the same expenditure of hours, Hence, it is contingent on rising productivity.

It is too early to gauge global productivity patterns currently and whether they differ from the USA. However, the most recent OECD "GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION", (OECD Economic Outlook, Volume 2017, Issue 2) suggests that productivity in 2017 continues to trend below previous recoveries despite the improvement over 2016. In the same edition, Figure 1.5 shows that global investment intensity remains significantly below the last peak of 2014, suggesting no

material basis for an uplift in future productivity. US manufacturing productivity grew only by 0.7% in 2017 compared to the average 1% annual growth between 2009 and 2017 (BLS February 01, 2018 release). This compares to 1.2% for the non-farm business sector in 2017 courtesy of the remarkable third quarter jump in productivity to 2.7% when GDP was grossly inflated.

It is therefore difficult to determine where these profits are coming from besides rising financial profits. According to the OECD global industrial growth and global retail sales have continued to oscillate around the 4% mark, the average for the last four years, and there is no current marked improvement. (Figure 1.2 C & D)

In fact, when the balance sheets of some of the leading industrial companies is analysed, it turns out that their profits have been financially massaged. In the case of Amazon, it is guilty of doing what Marx criticised the railway companies for doing in his day; capitalising running costs to avoid these costs burdening profits. In the case of the railway companies that applied to major repairs and in the case of Amazon to its treatment of leasing costs. Had Amazon not deferred these costs by capitalising them, its cash flow, instead of being positive, would be negative despite its low tax payments. Turning to Apple, its latest cash flow shows a multi-billion jump in bills receivable. This is nothing more than selling product forward on credit to boost holiday season sale figures, and it reinforces the poor projection for next quarter sales. This may explain why Apple resorted to software patches, designed intentionally or inadvertently, to encourage Apple users to upgrade their older iPhones for newer ones.

It was no accident therefore that FAANG shares fell further and faster than the general market between Friday and Monday. As I predicted in my last report, there is a bit of the bitcoin rubbing off on the FAANG shares. With the exception of Amazon, and more short-term Netflix, the business models of Apple, Facebook and Google are unravelling. It could thus be said that the FAANG group of corporations which led the bull rush are now reduced to the NA group.

But the same criticisms befall the other large corporations including General Motors, of which it was once said; "when it sneezed the economy caught a cold". Its GAAP adjusted revenue fell by nearly 5% adjusted for inflation and its cash flow by nearly \$1 billion once again adjusted for cash flow (2017 compared to 2016). GM's figures would have been worse had it not earned more income from its financial side, a factor which could quickly turn, once interest rate rises causes accelerated defaults. Of course, GM will pay no tax on its reduced profits because it has booked a \$7.3 billion tax charge under the new tax code.

The same applies to Boeing which has replaced Apple as the darling of Wall Street. Its quarterly operating margin increased by 2.5 pts from 9.4 pts in q4 2016 to 11.9 pts in 2017. This should have translated into a much stronger operating cash flow which it did not. While nominal operating cash flow increased from \$2.832 billion to \$2.904 billion (+3%), when adjusting for the value of the dollar and inflation, operating cash flow actually fell. This explains the all important current asset/liability ratio which fell by \$0.3 billion because current assets (cash and marketable securities) did not rise compared to liabilities which did. Moreover, compared to the stronger 2015 figures, Boeing's resurgence has some way to go to equal the revenue and profits for that year. And yet the amnesic stock market prostrated itself before Boeing, mesmerised by its headline figures. (http://s2.q4cdn.com/661678649/files/doc_financials/quarterly/2017/Q4/4Q17-Earnings-Release.pdf)

Hence it is important to dig below the surface when examining all these large corporations. None of these corporations have exceeded their 2015 performances in nominal terms let alone real terms, and the quality of their 2017 figures are similarly reduced. And yet, since 2015, their share prices on

average are up by a half. This tends to suggest the markets are running on fumes, intoxicating fumes, but fumes nonetheless. Thus, while it is true and undeniable that profits have improved, as Mr Roberts has said, this is reminiscent of 1937 when rising profits did not prevent the market falling back because the Fed raised interest rates and the government cut back on spending.

Conclusion.

This posting was held back until the results of Wednesday's all important 10-year bond auction was known. The uptake of these bonds was mediocre driving up the rate to 2.85%, the level which brought down the markets the previous week. The Dow also had its wildest session on Wednesday (since August 2015) when a rise of 381 reversed into a fall of 127 points before closing down 19 points. All stock markets closed down, with the NASDAQ, home to much of the tech industry, falling 0.9%.

The United States, because it has been the hegemonic economic power since the Second World War, is and remains the financial heart of the world economy. However, it is no longer the industrial heart. This unusual state of affairs means that the prospects for the world economy depends on the effect any financial disturbance has on China. After the financial crash of 2008, it was the growth in the Chinese economy, rather than Quantitative Easing, that reflated the world economy.

China will no longer be able to replicate this feat due to the legacy of debt resulting from its earlier reflation. If this financial disturbance disrupts Chinese economic production, which it can because the US remains the world's largest importer, particularly of manufactured goods, it will act as a brake on the world economy. A synchronised economic expansion could give way to a synchronised contraction.

The key point to consider is this. The mini-recession at the end of 2015 did not purge excess capital from the system including debt. The expansion which follows is paying the price. The transition of the world economy from rising animation (below average growth) to prosperity is blocked by this debt and the interest rates which govern it. The rise in interest rates will prejudice the US economy whose financial fragility is currently ignored. This was exemplified by today's (Thursday) announcement by the Bank of England that interest rates would have to rise faster because of a robust world economy, at a time when the fragile and highly leveraged British economy depends on low interest rates.

The world economy is thus caught in a unique paradigm, a foreshortened expansion based on an unresolved mini-recession two years ago. This will magnify the potential for a fundamental crash to shake off this legacy. As in 1937, this raises the spectre of war and we should add, of revolution, because following 2008, another crash would annihilate capitalism's credibility.

The concluding irony is that algorithms, which tend to hurt jobs, has on this occasion, also hurt the capitalist class by accelerating losses on the markets and creating greater uncertainty. Misused in the name of profit, they have created the very conditions they were supposed to prevent.