

FINANCIAL MARKETS APPROACH A YEAR END TEST.

*The US Federal Reserve launched Quantitative Easing (QE) **after** the 2008 Crash. Beginning this September, it has launched a new round of QE that dares not speak its name. This facility mimics the scale of QE1 at an annualised \$1.2 trillion, but has been initiated **before** the next Crash. Despite this injection, liquidity issues in the short term money markets keep building, and will reach a crescendo towards the year end, when the banks traditionally balance their books.*

It is most unusual for the FED to engage in emergency action prior to a Crash rather than after it. This demonstrates the lengths the bourgeois state is prepared to go to, to keep the bubble economy going. And what a bubble it is. In Graph 4 we will see how abnormal the current period is.

Concern is rising alongside rising interest rates in the US REPO market. The buzz of worry in financial circles is increasing. The most notable is Zoltan Pozsar who now works for Credit Suisse having made his name working for the New York FED (who are overseeing the REPO facility). (Note 1.) His arguments are complex but boil down to this; the FED is misdirecting its efforts and underestimating the task at hand. As Pozsar says, there is a possibility that the FED could lose control of interest rates, and should that happen, it is clear the over-inflated and thin-skinned speculative bubble would burst.

For a few months, Wall Street has ignored the problems in the financial plumbing that feeds it, satisfied that plumb FED was in attendance. The significance of the current escalation in concern, is that it is growing, despite plumb FED being in attendance. However, while the FED is dealing with symptoms, it has not offered a diagnosis, what exactly is causing this repulsion. The earlier explanations of heavy tax payments, high issuances of Treasury Bonds and restrictive bank regulation are now being dismissed as too light weight.

There is clearly a fundamental liquidity crisis and it has everything to do with leverage being at extreme levels, while the flow of surplus value supporting this leverage is not only ebbing, but capital is actually being destroyed through growing bad debts. (For example Chevron's \$11 billion asset write down today focused on its shale holdings. Cash flow in tight oil and gas last quarter showed a deficit of \$1.26 billion <https://www.nasdaq.com/articles/has-u.s.-shale-seen-its-profits-peak-2019-11-22>.) If the reserves in banks are at a low, it is because corporations are depositing less cash as their profits crash, while debtors are increasingly unable to repay their borrowings or interest on their borrowings. This applies to the retail sector, the transport sector, commercial property as much as it does to shale oil.

Currently fictitious capital stands at 2.5 times GDP (Based on Credit Suisse data). This is unprecedented. Past surplus value is petrified and congealed by speculation, and as the bubble swells, more capital is needed for every incremental increase, except of course that the source of this surplus value is drying up. Thus the bubble is struggling to remain inflated. That is why bank reserves are failing, they have been consumed by speculative trades.

Graph 1, below shows the degree of leverage, This is the market capitalisation of all shares measured against GDP. On this measure the bubble is larger in absolute and relative terms compared to the dot.com bubble, whose bursting saw the Nasdaq, the market where this bubble was focused, fall 78%. It should be observed that this year the ratio has approached 160% of GDP.

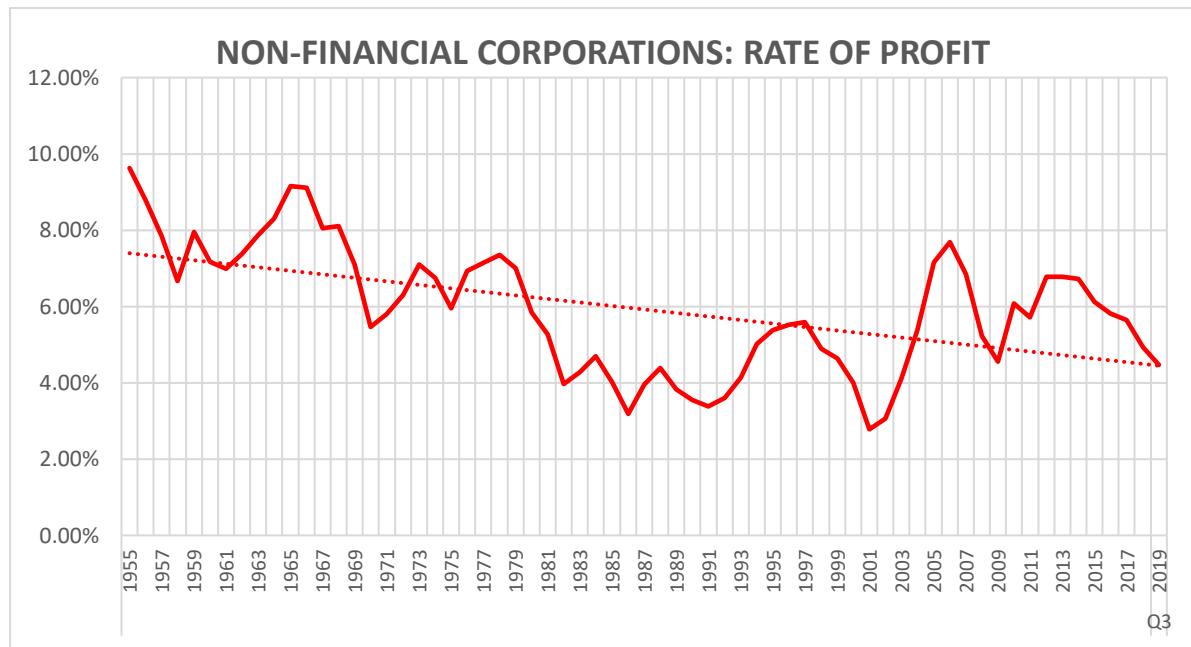
Graph 1.



<https://razorwealth.com/buffett-indicator-2019-chart-update-market-cap-divided-by-gdp/>

The flip side of this equation is the rate of profit. The black hole at the centre of the financial universe. Those speculators who believe you cannot fight the FED, have no inkling that in the end, it is the power of the rate of profit that decides the future of the economy, not the FED.

Graph 2.

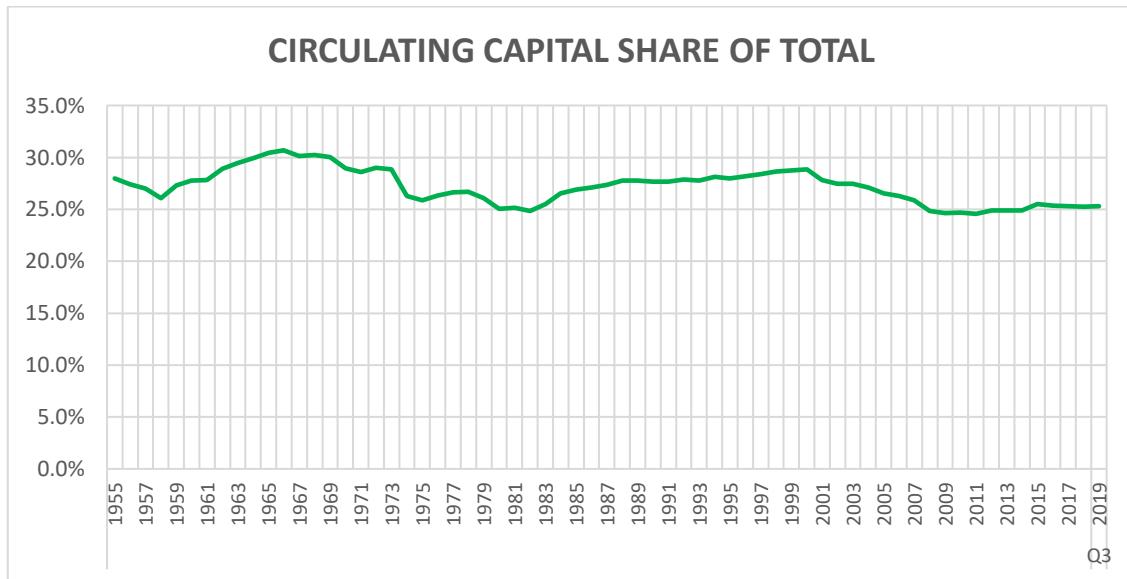


Source: Spreadsheet "Table 1.14 1955 -2018" attached)

The reader should note the current rate of profit stands at 4.48% which is below the average 4.55% which prevailed in 2009, the trough following the Crash of 2008. The reader should also discard all the rates of profit or more properly rates of return prepared by other "Marxists". It is time to get serious.

Their rates of profit describe little about the real world and teach us even less. This can be clearly seen when we try to compare their rates of profit to the price to earnings ratios found in the markets. There is no symmetry using their rates, which would yield inverted rates of profit of 6 to 9. Graph 3 shows the order of their mistake by providing the share of total capital contributed by circulating capital.

Graph 3.



The BEA does not provide gross output on a legal basis only an industry basis. This means there is no gross output for the Corporate Sector. This has to be extrapolated using turnover and GVA. Until recently I was handicapped by my lack of maths so could not find the formula to derive Gross Output, forcing me to use a calculator. I was very fortunate to bump into a statistician who provided me with the formula in minutes. Here it is:

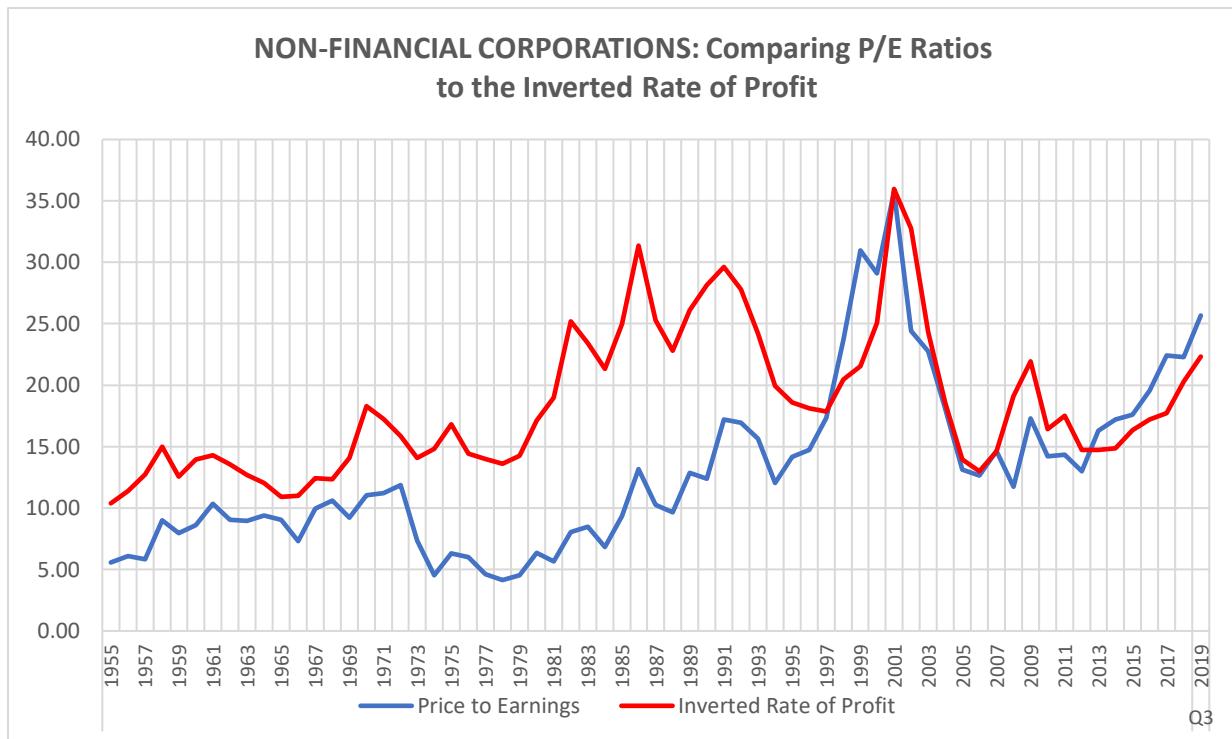
$$\frac{(\text{t.o.} \times \text{GVA}) + \text{GVA}}{2} \quad \text{where t.o. stands for the rate of turnover and GVA for Gross Value Added}$$

Using this formula and applying the turnover for the goods sector I was able to derive Gross Output going back to 1955 and through it to derive circulating capital for the same period as well. When added to fixed capital, the total capital was obtained. By dividing unadjusted pre-tax profits into the resulting total capital, the rate of profit found in Graph 2 was obtained. All the data and formulae can be found in the attached spreadsheet.

I was also able to access FRED's (Federal Reserve Economic Data published by the St Louis FED) vintage series of tables for the market cap of Non-Financial Corporations extending back beyond 1955. I use 1955 as a cut off because of the lack of accuracy in earlier years. All comparisons are for non-financial corporations as the vintage series does not provide total corporate market cap. Therefore the comparisons here are slightly different to the earlier posting which looked at total corporate which included financial corporations.

This has produced not only an interesting graph, Graph 4, but an exciting graph, which tells a whole story. It compares the inverted rate of profit, the rock on which capitalism is based, with the price to earnings ratios of all listed corporations, not only the Dow or S&P but many thousands of listed corporations. (For those who have trouble conceptualising the inverted rate of profit, it is the upside down rate of profit. Instead of profit over capital it is capital over profit. The lower the rate of profit the higher the inverted rate of profit. So if the rate of profit is 5% then inverted rate would be 20.).

Graph 4.



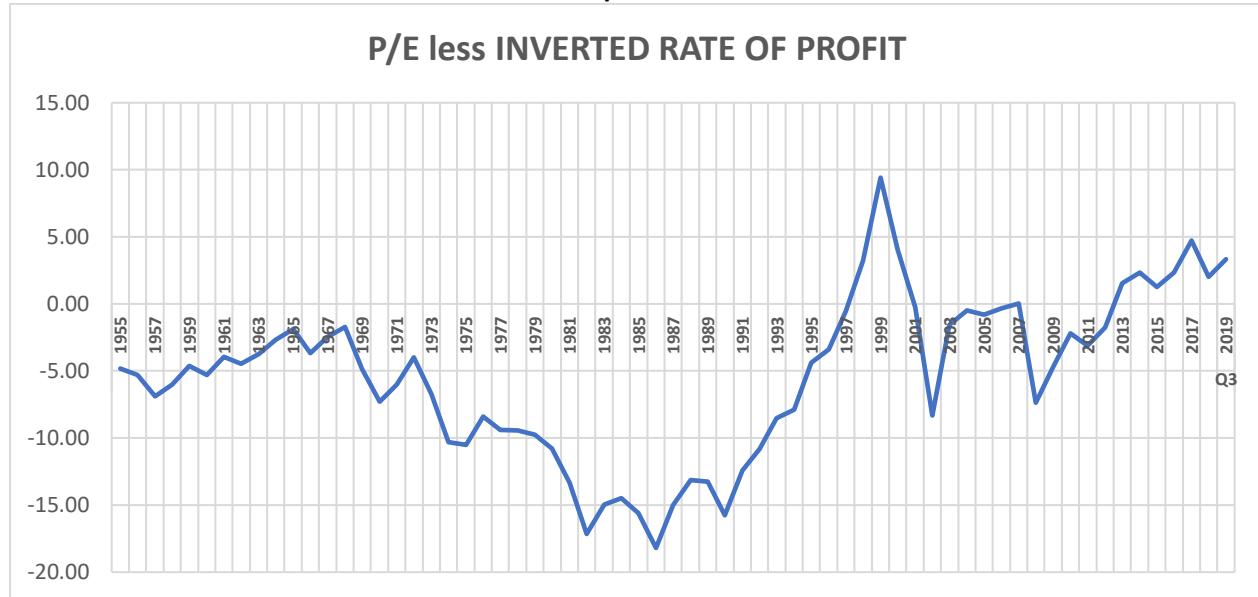
What makes this graph so important? It describes two periods, the one where the inverted rate of profit resides above the P/E ratio. In other words the multiple of the rate of profit is bigger than the multiple for the P/E ratio. This period extended to the mid-1990s when globalisation kicked in. The second period follows on from this period, spanning the years from the mid-90s to today.

The normal state occurs in the first period. Normally the P/E multiple does not exceed the Profit multiple. The reason for this is that not all profit can be paid out in dividends to support the fictitious multiple, the P/E multiple. Some profit has to be retained for investment and other purposes. This breaks down after 1997 when the market begins to soar to its peak in 2000. Now it the case that the fictitious multiple has broken out of the embrace of the real multiple, the rate of profit.

The result was predictable, the dotcom crash. It proved that the profit multiple cannot be ignored. The same illusion has re-appeared. In 2012 the fictitious multiple once again breaks above the profit multiple. While the gap is less than in the run up to 2000, the duration is more extensive. Cumulatively it may be of the same magnitude as the run up to 2000. These deviations can be seen more clearly in the Graph below which tracks the difference between the two series. But before examining the following graph it is worth noting that in 2008, the fictitious rate did not exceed the real rate. The Crash in 2008 was due to a speculative frenzy in only one part of the market, residential mortgages, rather than a generalised frenzy.

Graph 5 below shows there are only two phases when the difference between the two ratios rose above 0%, post 1997 and post 2012 to the present conjuncture.

Graph 5.



Conclusion.

This is the reason for the stresses in the money markets. Banks are running out of money because the money coming in is receding, while the money (credit) going out to finance the bubble, is rising. The pundits who reckon the banks can simply print money or issue credit, have been shown to be wrong. Banks centralise, store and circulate value, but they do not create it.

Nothing must threaten this bubble. If Trump blinked today in the trade war, he did not do so because of what was in front of him, China, but what was behind him, an increasingly fragile economy. If the employment data was padded, it was to protect the market. If the FED is diving into the REPO market, it is to protect the market. It appears it is not the banks that are too big to fail, it is the bubble that is too big to burst.

Can it remain inflated indefinitely? Clearly not, the bigger the deviation of the fictitious multiple from the real multiple, the greater the fragility, the greater the potential fall-out. This article did not concern itself with the argument over whether it has been the fall in the rate of profit that has encouraged speculative excesses. In any case the rate of interest, rather than the rate of profit, plays a bigger role here. Its single minded purpose was to show that the fictitious multiple in the end is limited by the real multiple. Will the economy survive year end? If it does it will be a close call.

Note 1. WHAT IS THE REPO MARKET?

Bloomberg answers: *It's where piles of cash and pools of securities meet, resulting in more than \$3 trillion in debt being financed each day. Repo is short for repurchase agreements, transactions that amount to collateralized short-term loans, often made overnight. Repo deals let big investors -- such as mutual funds -- make money by briefly lending cash that might otherwise sit idle, and enable banks and broker-dealers to get needed financing by loaning out securities they hold in return. A healthy repo market is more than the world's biggest pawn shop: It helps a wide range of other transactions go more smoothly -- including trading in the over \$16 trillion U.S. Treasury market.* <https://www.bloomberg.com/news/articles/2019-09-19/the-repo-market-s-a-mess-what-s-the-repo-market-quicktake> In other words it is the interface between banks with temporary surplus cash meeting financial institutions that are short of cash on a daily or weekly basis. Cash is swapped in return for highly rated collateral (though it must be said this collateral may have been sworn to more than one lender!).

Brian Green, 12th December 2019.