THIS IS GOING TO BE THE HARDEST WINTER SINCE THE WAR!

The trailing winds of the pandemic hurricane are now howling, and it is only the start of winter. The US recorded 101,461 infections on Friday, most of Europe is locked down or close to it, and on Thursday England will go into lockdown. Society and its structures have already been weakened by the leading winds. This article looks at US third quarter data and the next article will look at the equivalent Chinese data.

Trump is self-isolating in his delusional bubble. With the infection rate rising above 100,000 and heading for 200,000 sometime in November, he continues to dismiss the virus "after having turned it around" a fact obscured by "medical professionals padding the mortality figures for financial gain". Frantic utterances by a desperate and floundering politician. The deluge of early and postal voting shows he is going to be thrashed on the 3rd of November, and he knows it. The only question is how quickly this will be followed by divorce and bankruptcy. The demise of a populist conman is never a pleasant sight.

This week the BEA published its first estimate of 3rd Quarter GDP. This was preceded by China's release of its own figures. US GDP data surprised on the upside, but how reliable is this data? This is one of the questions this article addresses.

The difference between Gross Domestic Product and value produced.

The System of National Accounts (SNA) is credible provided sales are not duplicated and provided the mere exchange of money is not confused with a real transaction involving either the production or circulation of a commodity. The starting point of the SNA is the sale, the exchange of commodities for money. Again, this is correct. Only through sale is the value produced realised and profit made. If there is no sale, then not only is no profit made, but capital is lost.

But total sales do not equate to total product, or the measured value of production (GDP). The reason for this is inventory or stock. Inventories can mean previously produced labour being consumed currently, or current labour in the form of inventories being carried forward to be consumed in the future.

The table below explains the difference between sales and product.

example	Stock b/f	Annual sales	Stock c/f	Annual Product (GDP)
A	10bn	100bn	10bn	100bn
B	10bn	100bn	20bn	110bn
C	20bn	100bn	10bn	90bn

b/f means brought forward and c/f means carried forward.

In all cases annual sales are constant at 100bn. However Gross Domestic Product changes depending on the amount of inventory brought forward (b/f) from the previous calendar year, or, carried forward (c/f) to the following year. The formula to convert sales into production is therefore,

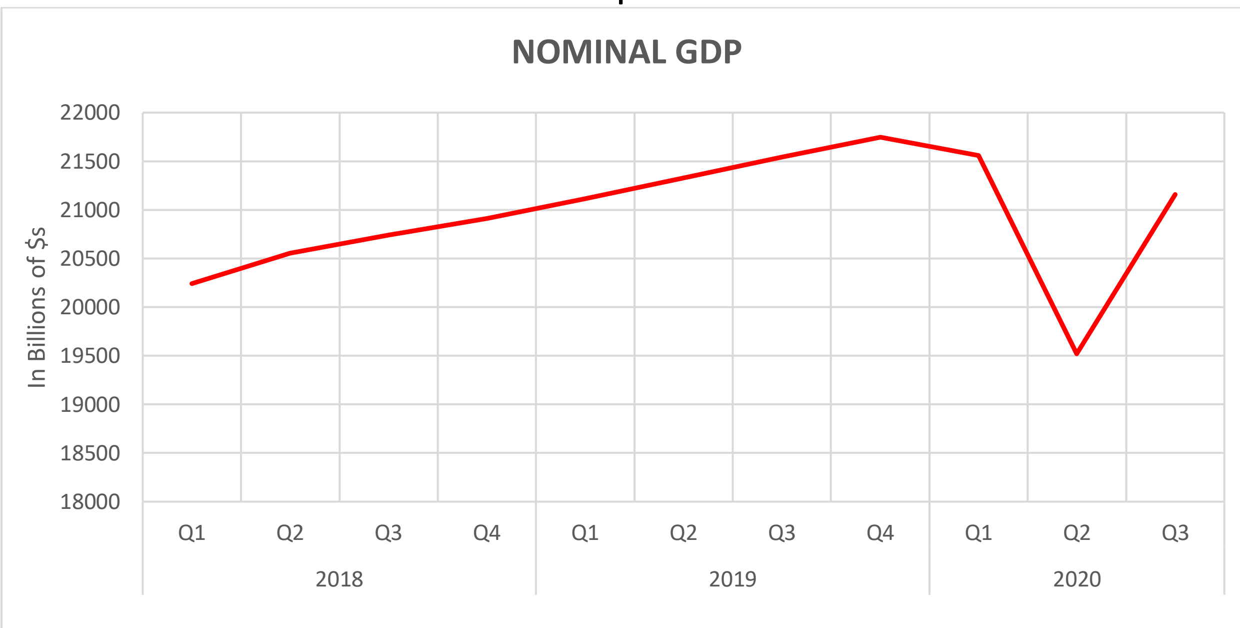
annual sales <u>less</u> inventory brought forward <u>plus</u> inventory carried forward equals production.

This methodology is particularly important in the pandemic. This pandemic has been characterised by substantial fiscal injections into the economy. In the case of the US, up to $2.8 trillion, equivalent to 14% of GDP, has been injected. Without this injection GDP would have fallen by a larger margin because of the loss of sales together with the resulting boost to inventories. I have pointed this out a number of times on

Michael Roberts site. It is a common mistake by Marxists to take the crude change in GDP as a marker of changes to produced value in a given period.

The first graph plots nominal GDP per quarter from 2018 to Q3 of 2020.

Graph 1.



(Table 1.17.5. Gross Domestic Product, Gross Domestic Income, and Other Major NIPA Aggregates)

We find the GDP fell by $2.2 trillion between the last quarter of 2019 and the second quarter of 2020. This is a loss of roughly 10% in GDP. At first sight this loss looks incongruous given the severity of the lockdown and the collapse in production. Graph 2 begins to refine this actual loss by examining inventories.

Graph 2.

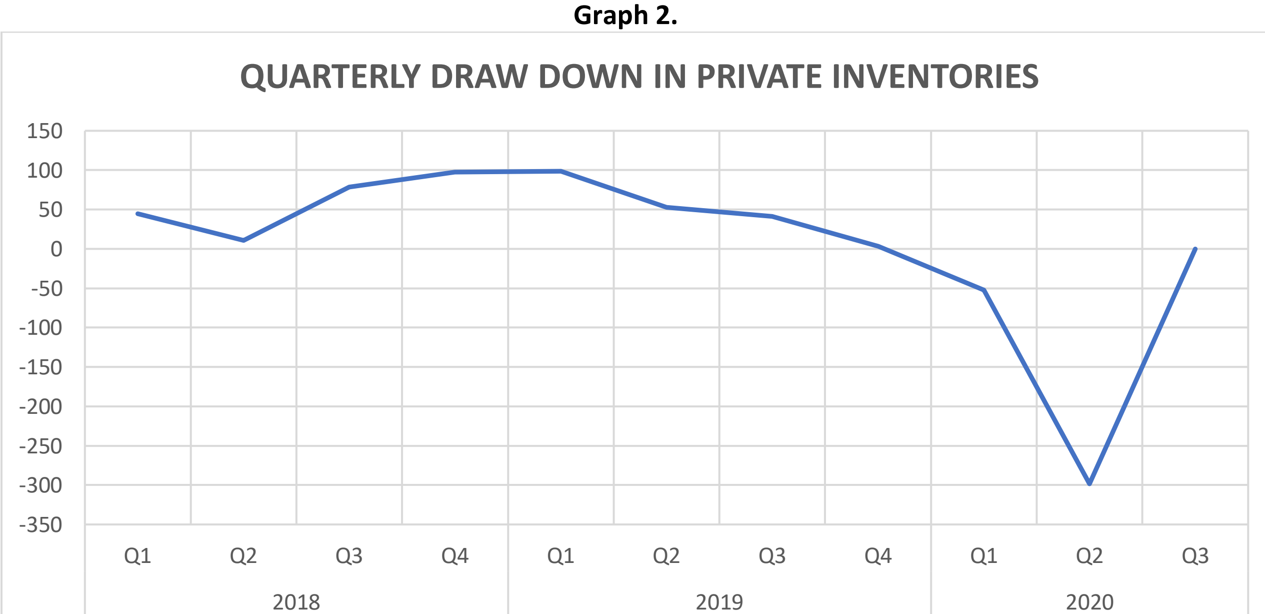


Table 5.7.5B. Change in Private Inventories by Industry

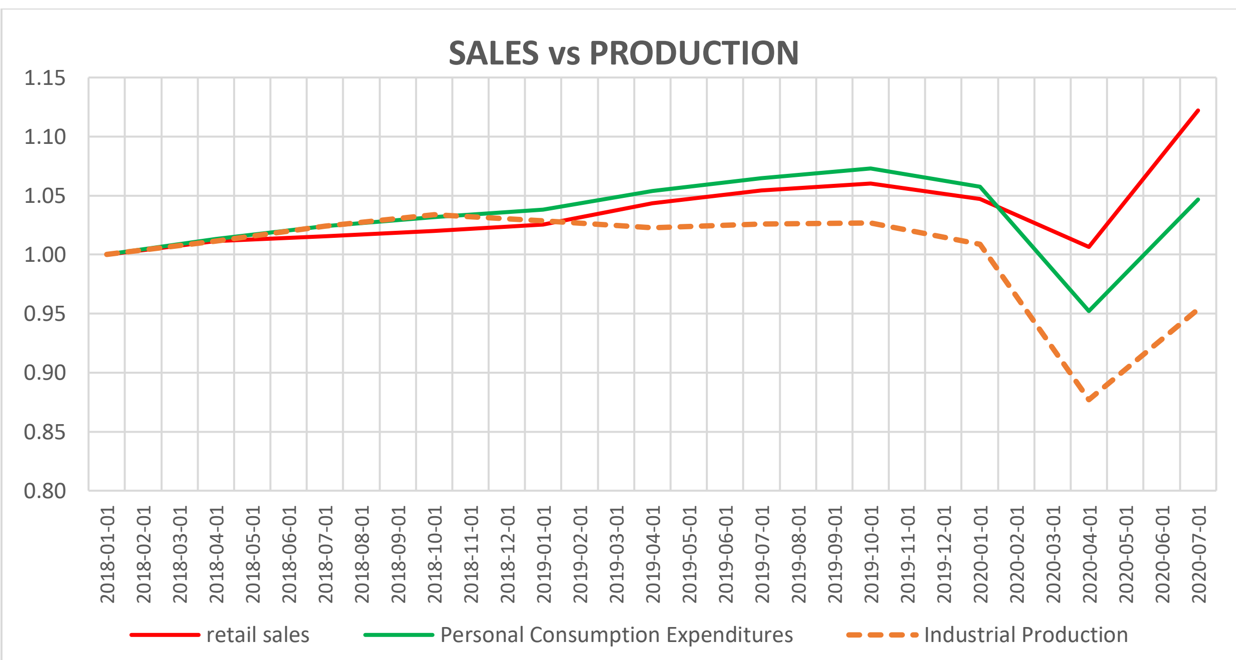
We note that there has been a cumulative $350 billion draw-down of inventories up to the 2nd quarter of 2020. Without this draw down, GDP would have fallen by $2.55 trillion not $2.2 trillion. Instead of a fall of around 10% in GDP the fall would have been 12%, everything else being equal. So, this injection has completely distorted GDP estimates through its positive effect on sales and resulting negative effect on inventories. I do not accept that the fall in value was 12%, but much larger. The aggregate weekly hours worked in industry and services suggests this. In time and provided the China effect on data diminishes, revisions by the BEA may lead to the same conclusion. If we assume that $1.1 trillion of the CARES Act was spent in the quarter this would have turned a $3.3 trillion fall in GDP into the reported $2.2 trillion fall.

The third quarter bounce back.

Nominally third quarter GDP is back to 97.3% of its 2019 peak. In terms of a running quarterly average the fall in GDP is 3.2% or $20746.27 trillion in 2020 versus $21433.23 trillion for the whole of 2019. Clearly this cannot be real. When dissecting the figures, we find that Q3 GDP vs the year earlier figure is down only 1.81%. This comprises a fall in Personal Consumption Expenditures (PCE) of only 1.74%, non-residential investment of 4.87% and net exports down 13.6%. Thus, the GDP figure is propped up by the PCE figure alone. Readers know I have challenged the veracity of consumption data for some time.

I reintroduce a much-used graph which has been updated to the third quarter.

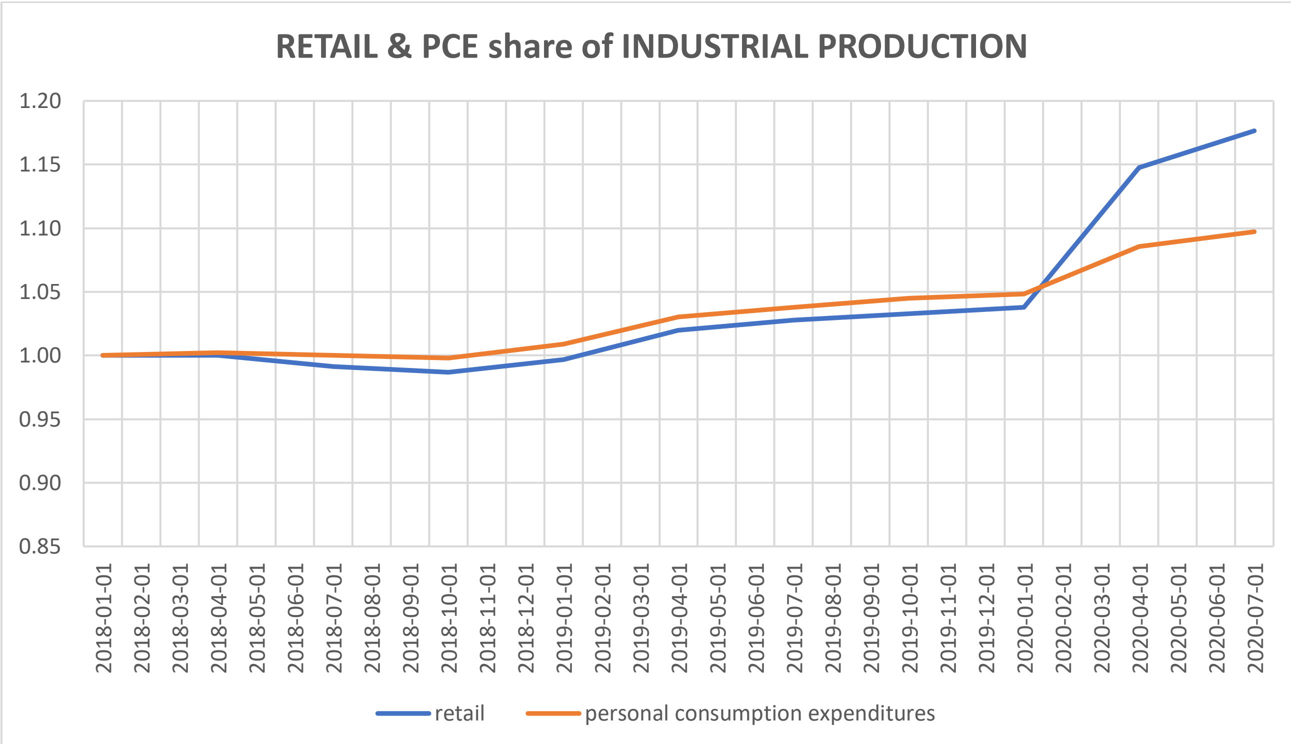
Graph 3.



(Source: FRED Tables RSXFX for Retail, PCE for Personal Consumption Expenditures and INDPRO for production.)

Here we see a gentle but consistent fall in industrial production from the end of 2018 up to the outbreak of the pandemic, after which there is a very sharp fall followed by a restricted recovery. This however is is not mirrored by the movement on the consumption side, which on balance has risen prior to the pandemic. The result has been a consistent divergence up to the pandemic followed by an amplification of the divergence. Graph 4 below plots the divergences.

Graph 4.



(Source Fred Table

We note the divergences increasing from the end of 2018 by 5 points which then opened up 18 points and 10 points during the pandemic. Clearly, we would expect some divergence during the pandemic because of the effect on inventories. And we would expect retail to diverge the most as people staying at home consume more goods and relatively fewer services such as travel, eating out and entertainment.

But it is the fact that these divergences were occurring before the pandemic which is a source of concern. Either prices for industry were falling or prices for retail were increasing and with it profit margins, or the BEA was using the wrong deflator which meant that the volume of retail sales and other consumption items was being overstated. According to the most recent data from the Stern Business School, the change in margins does not account for the deviation between industrial and retail prices. http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html

Nor can the 18-point divergence between production and retail sales be laid at the door of inventories in this Quarter. As Graph 5 below shows, there has been a build rather than a draw on inventories. Indeed, the build in Q3 more or less reverses the draw in Q2. Nor can the divergence be explained by changes in next exports. Certainly, the growth in imports has exceeded the growth of exports meaning more goods arrived in the country than left. According to Moody's Analytics net imports increased by $186 billion in the third quarter or roughly half the build in inventories. In other words, much of the increase in imports went to build inventories rather than fed into retail sales. Thus, the inescapable conclusion is that sales in the USA are overstated and that this has in turn inflated the growth in GDP. To those who criticise and point finger at the accuracy of Chinese data, let me assure them, the US data is under suspicion as well.

Graph 5.

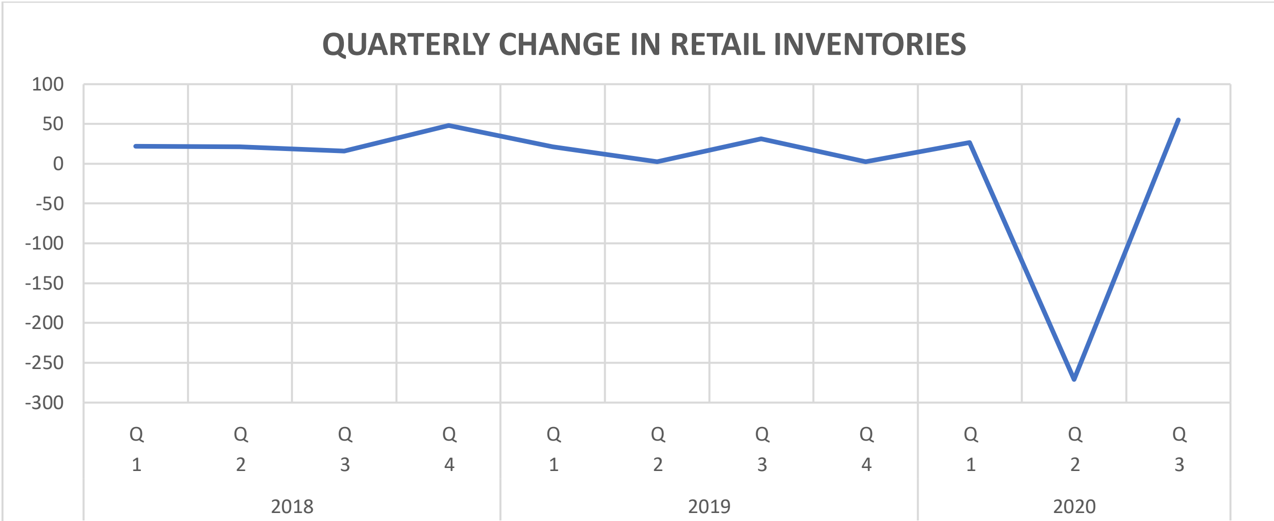


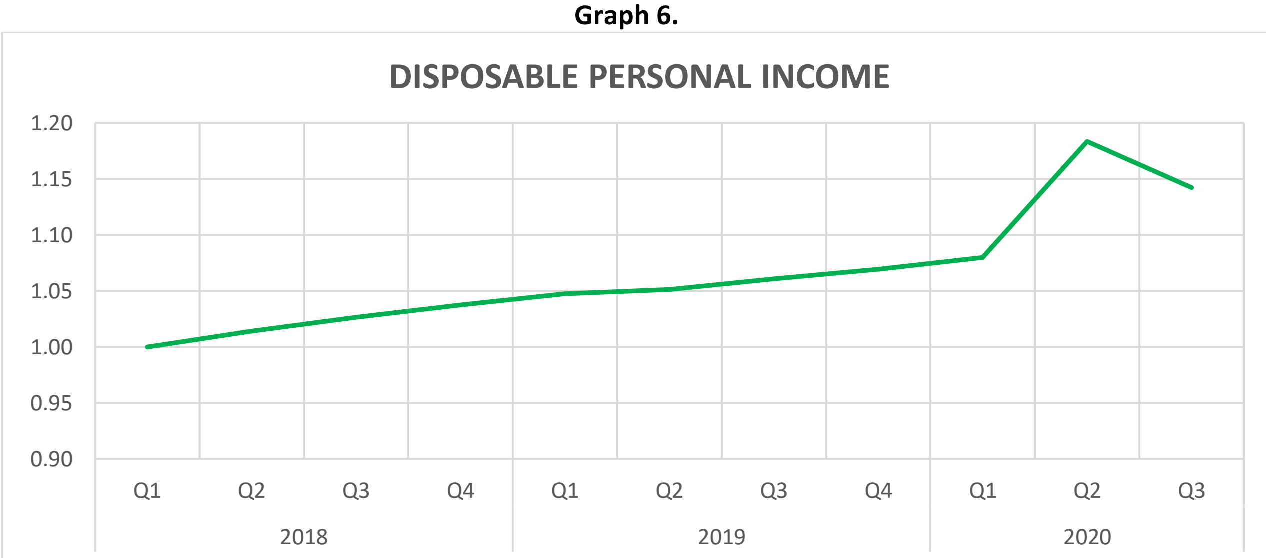
Table 5.7.5B. Change in Private Inventories by Industry

Gross Domestic Product and Gross Domestic Income.

The other area of concern relates to the relationship between Gross Domestic Product and Gross Domestic income. This relationship is described in NIPA Table 1.15.5. Theoretically, the three facets of production, expenditure and income should coincide. Gross Value Added is the common denominator. Consumption + investment should add up to it on the expenditure side, while consumer production and investment production should add up to it on the production side. (We set aside savings, which is a balancing item, as we do with credit formation, which distorts the former.)

Table 1.15.5 confirms that production and income moved in step during the all-important second quarter. No doubt this will be repeated in the third quarter when National and Domestic Income are released. But immediately the question is raised, what happened to the $2.8 trillion, most of it from the CARES Act which ran from March 27th to July 26th. It did not disappear in Las Vegas.

Graph 6.

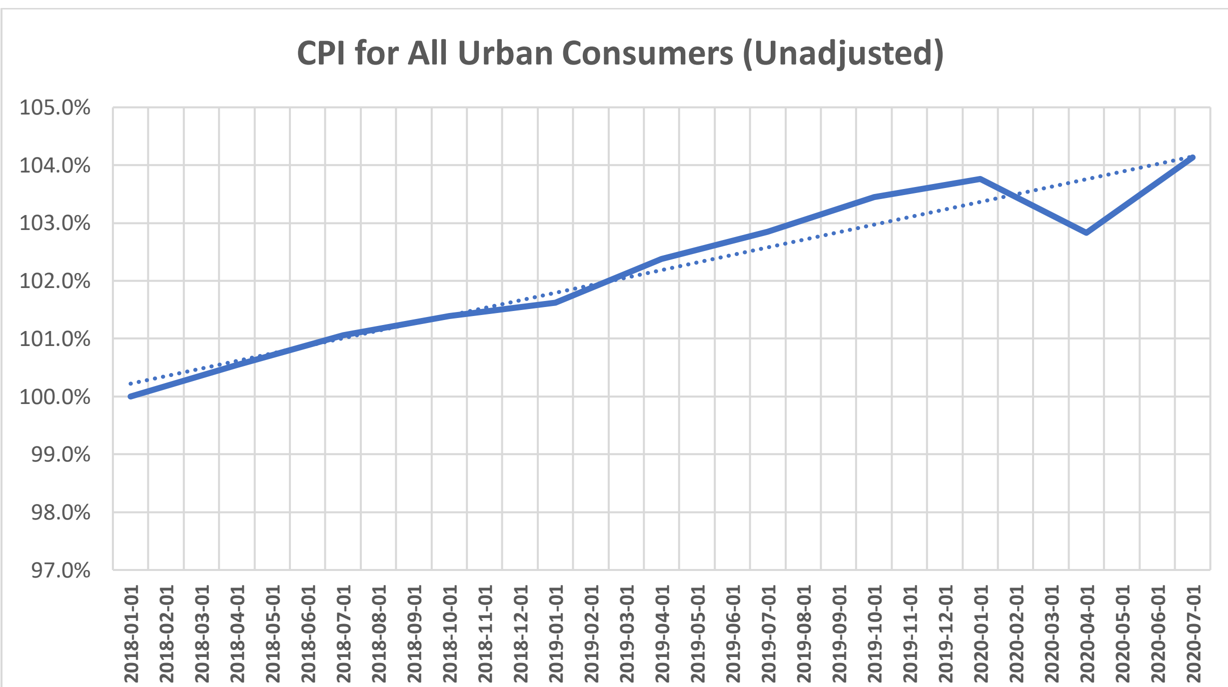


Line 24 of the Table provides the answer. Under the heading "*After-tax income received by the personal sector*" we find a surge in income. This is reproduced in Graph 7 above. It shows the effect of this growth in income as a result of the CARES Act despite the mass layoffs that occurred at the time. Net disposable income surprisingly went up by 10%. As the CARES Act ended in the early part of the third Quarter its absence is noticeable through the subsequent fall in income. Nonetheless its residual impact is still discernable because net income remains elevated despite it all, up 6% compared to the first quarter.

This has an important bearing on MMT theory. Hypothetically, when the monetizing of income meets reduced production it should have inflationary consequences. According to the data provided by the Census Bureau this is not the case. Even when examined in greater detail, to two decimal points as in Graph 8 this is not the case.

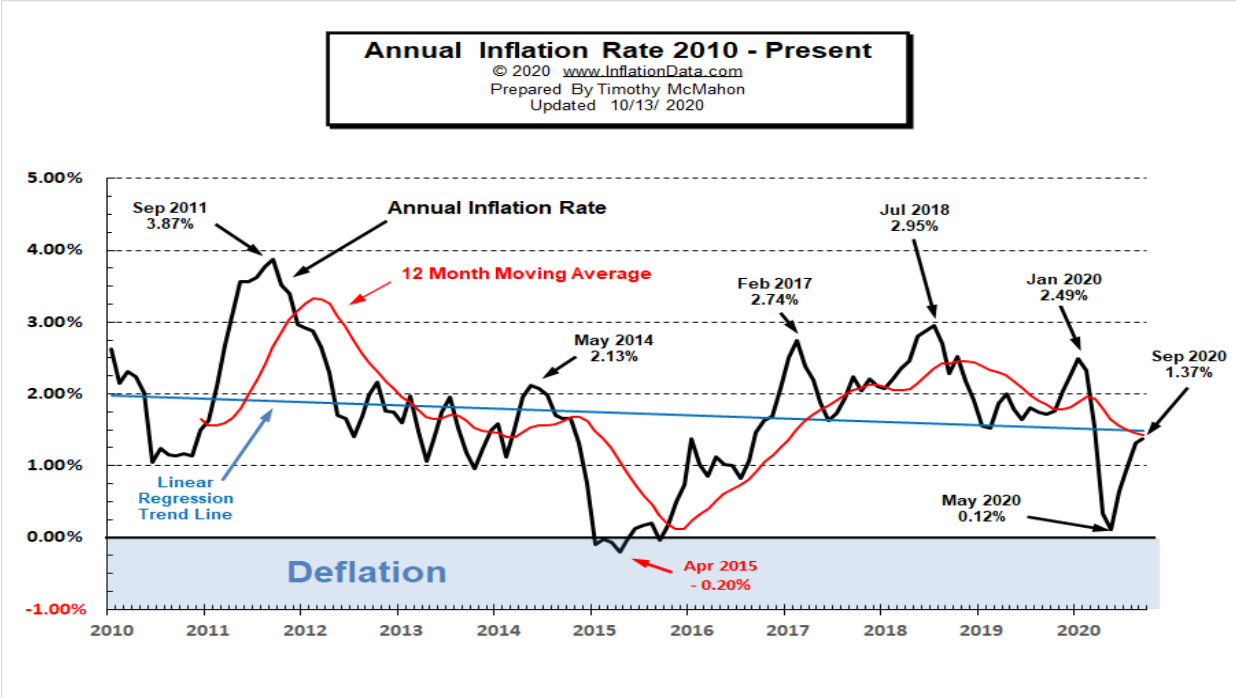
It is also true when examined in finer detail, for example food and beverage prices which are sensitive to changes in demand. They rose at an annual rate of 4.01% vs 1.76% for the index as a whole. I remain of the opinion that since the revisions to price indexes, the inflation data remains inaccurate and that inflation, is well, deflated.

Graph 7.



(Source: FRED Table CPIAUCSL)

Graph 8.

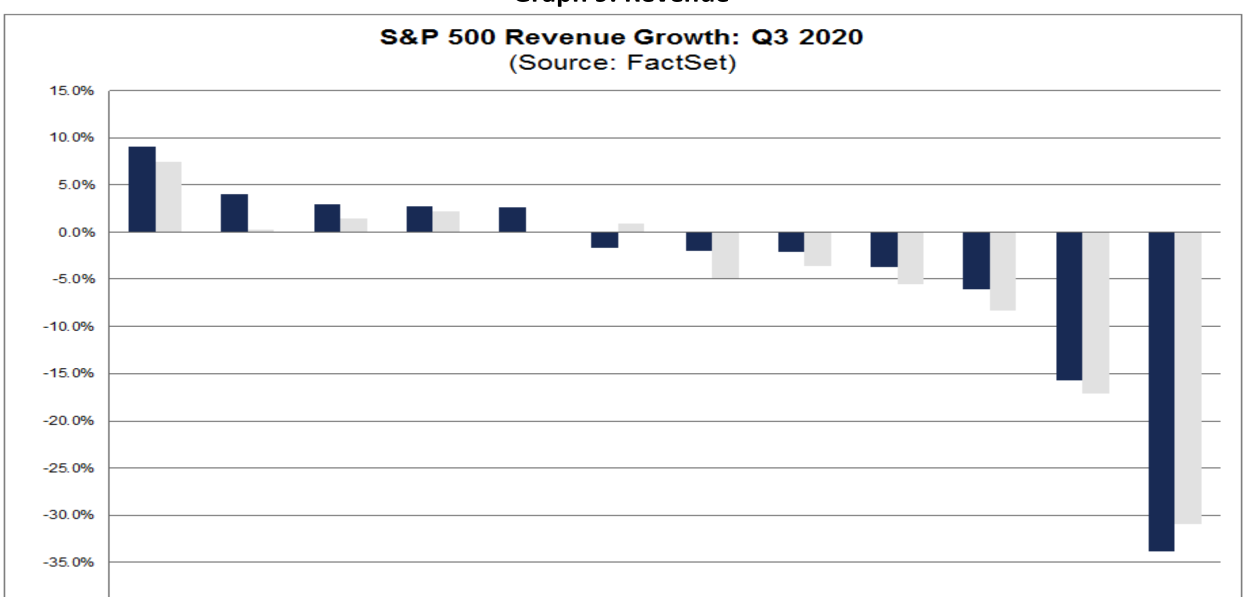


https://inflationdata.com/Inflation/Inflation_Rate/CurrentInflation.asp?reloaded=true

The outlook for profits.

FactSet's latest report covers 81% of S&P company reports. It shows, that whereas retail sales have grown 6% annually, and while PCEs and Total Business Sales are essentially flat, S&P companies so far are down 2.1% and that is before we adjust for share buy backs.

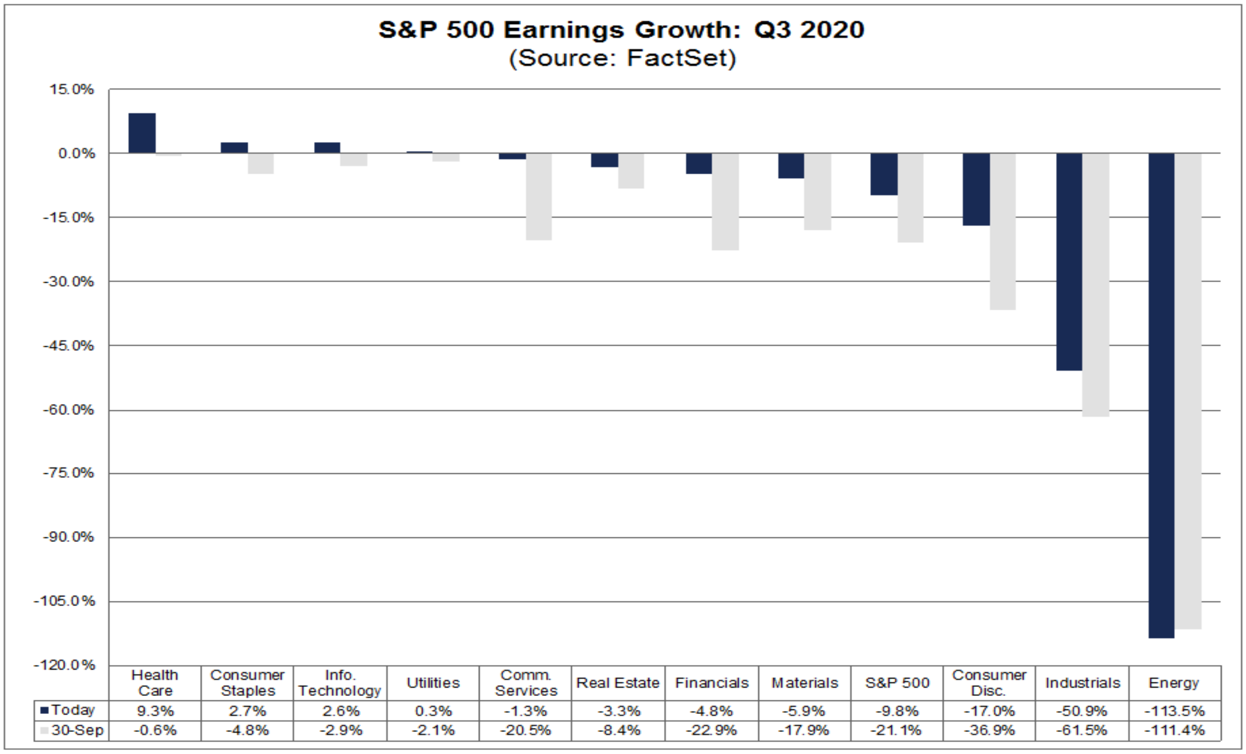
Graph 9. Revenue



	Health Care	Comm. Services	Info. Technology	Consumer Staples	Consumer Disc.	Utilities	Financials	S&P 500	Real Estate	Materials	Industrials	Energy
Today	9.1%	4.0%	3.0%	2.7%	2.6%	-1.7%	-2.0%	-2.1%	-3.8%	-6.1%	-15.6%	-33.9%
30-Sep	7.4%	0.3%	1.4%	2.1%	-0.1%	0.9%	-5.0%	-3.6%	-5.5%	-8.4%	-17.1%	-30.9%

In terms of profits, earnings per share are down 9.6% compared to the previous year.

Graph 10. Profits



	Health Care	Consumer Staples	Info. Technology	Utilities	Comm. Services	Real Estate	Financials	Materials	S&P 500	Consumer Disc.	Industrials	Energy
Today	9.3%	2.7%	2.6%	0.3%	-1.3%	-3.3%	-4.8%	-5.9%	-9.8%	-17.0%	-50.9%	-113.5%
30-Sep	-0.6%	-4.8%	-2.9%	-2.1%	-20.5%	-8.4%	-22.9%	-17.9%	-21.1%	-36.9%	-61.5%	-111.4%

https://insight.factset.com/sp-500-earnings-season-update-october-30-2020

While the fall of 9.6% is likely to be revised upwards once all companies have reported, it looks likely that the fall in profits adjusted for buy backs, will be closer to 10% than 5%. Thus annual 2020 profits look dismal particularly given the resurgence in the pandemic this fall impacting the fourth quarter. It is also notable that the resurgence is fastest in those "Red" states visited by Trump on the stump and where governors or courts have failed to impose tighter restrictions.

With infections increasing by 25% each week it will only take 3 weeks to hit a daily rate of 200,000 which in terms of the entire population of the USA is an inflection point, the point hospitals start over-flowing in the worst hit areas. It is the point at which lockdowns become inevitable. And they will happen despite "loser" Trump's rear-guard actions until he is evicted from the White House in January, with him leaving without a mask through the front door, and Melania leaving through the back door. Given this outlook, banks which reduced their bad debt provisions to massage profits, will be found wanting in the extreme.

Outlook.

As I said previously, how bad 2020 will be, will only be known at midnight on the 31st December. Certainly, the IMF, the OECD, the World Bank and the swarm of analysists through their projections, have underestimated the effect of the pandemic on the last quarter of 2020 and first quarter 2021. They have failed to see, that the worst is ahead of us, not behind us, with or without a vaccine. This is going to be the hardest winter in the Northern Hemisphere since the War.

We are rapidly approaching the climax of this pandemic, one which will test the very fabric of capitalist society. Eruptions are bound to escalate, probably beginning in the Southern Hemisphere, as the economic toll from the pandemic forces workers to fight to protect themselves.

The Democrats will emerge victorious in the elections, and probably be the bosses of both Houses of Congress as well as the White House. As for their opponents, God's Own Party (sic) Republicans, they will be thrown back a generation, reduced to a rump party of the right, an amalgam of libertarians and the religious, with their diminished leaders going to bed each night cursing the name of Trump.

But before the Democrats crow, they will inherit a broken economy. Inheriting a crisis ridden economy is like entering a war. On day one of the battle, all carefully prepared plans become redundant and must be cast aside, forcing the generals to improvise. So too with the Democrats. Capital is an unrelenting taskmaster as well as unforgiving. The Democrats, like the generals before them, will abandon their promises and sacrifice their disappointed supporters on the alter of profit. Within a year, the Biden, Clinton, Obama troika which dominates the Democratic Party will be just as discredited as Trump. These are the perspectives we need to build on.

Additionally, the US economy will have been diminished in terms of China. The US was superficially and nominally (in terms of Dollars) 30% larger than China. By the end of 2021, this will have halved to 15%, and by 2026 they will stand as equals. The window of opportunity for the US to maintain its economic hegemony is rapidly closing. The first victim of a safe and effective vaccine could very well be war.

The greed of capitalism fuelled the pandemic through inequality and its siblings - poverty, overcrowding, poor nutrition, pared down medical services. The first modern international pandemic, Spanish Flu, followed WW1. The second pandemic, COVID could precede WW3. This we must prevent.

Brian Green, 1st November 2020.