

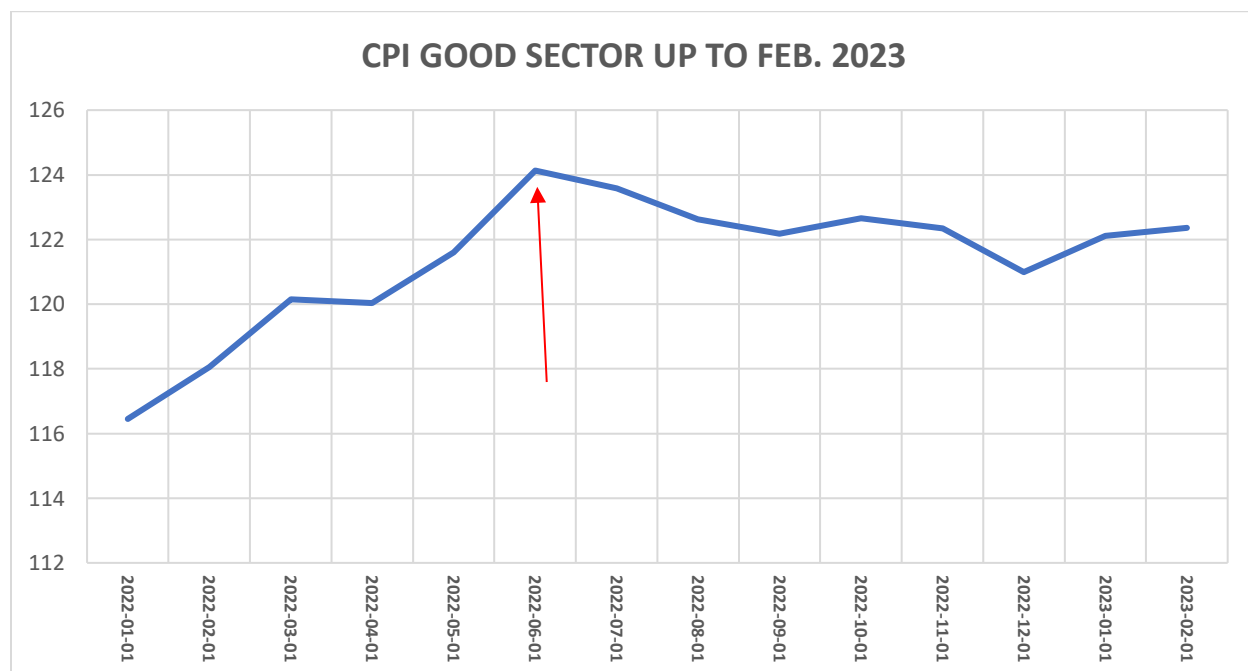
## THE STARK CHOICES FACING THE FED, INFLATION vs SAVING THE BANKS, OR IS IT SO STARK?

*As we shall see, the delayed banking crisis has played into the hands of the FED.*

The above statement may appear contrarian, but Wall Street last week did not think so. Unusually, despite being caught up in the storm of an escalating banking crisis, the markets ended the week up on balance and this rally continued into this week. There are two reasons for this. Firstly, that investors remain convinced that the FED and the Treasury (US government) will backstop any losses, and secondly, that the fall in inflation provides more wriggle room for the FED over monetary policy.

I have read a number of articles written by various Marxian analysts, the best of which is by [Michael Hudson](#). However what they all miss out is an analysis of inflation which is why I will begin with this analysis. The back of inflation has been broken. Prices are receding. Were it not for the US led disruption of supply chains, unpredictable climatic events, wars, we would now be heading towards disinflation, and if not disinflation at least below the as yet unrevised 2% inflation goal. (Also the Ukrainian war is a known unknown. Will Poland openly enter the war to prevent a Ukrainian defeat or will Xi convince Zelensky to negotiate?) To support this view, here are a number of graphs. Graph 1 is effectively the US RPI. The US Commerce Department does not issue an official RPI but it does issue a CPI for goods both durable and non-durable. The CPI below, really a RPI, is a blend of these two CPI's weighted by sales in both segments.

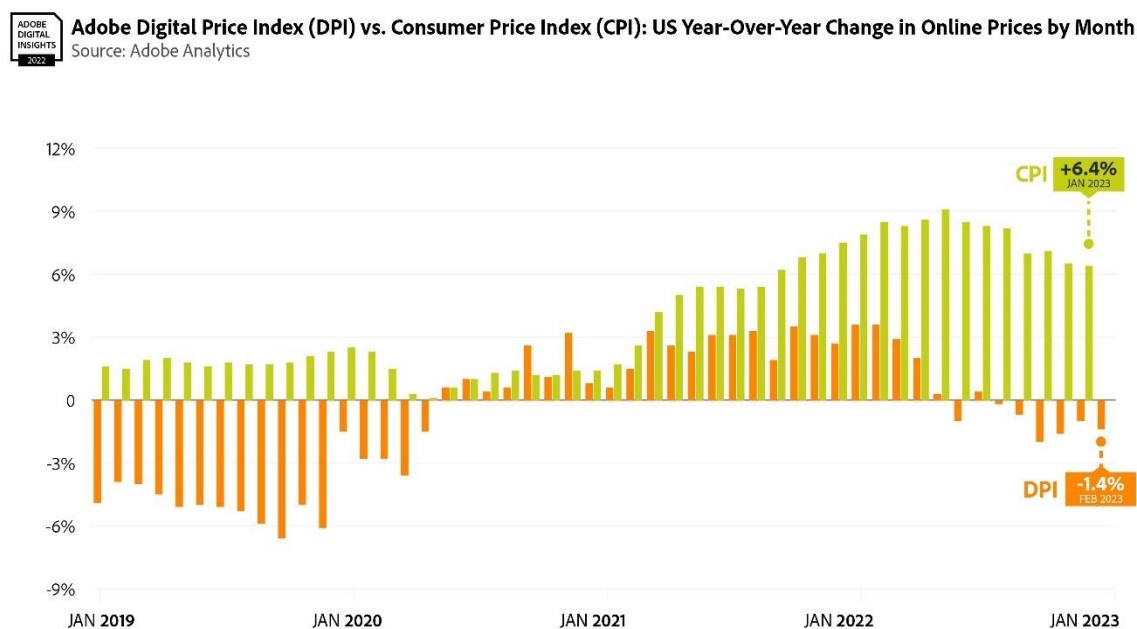
Graph 1.



Throughout our analysis June 2022 is the key because that is when inflation peaked, which means the run up to June is still distorting the actual **annual** inflation trend. Thus the calculations are based on June as the base month. Using this base, goods inflation, though up over January and February for reasons that escape me, because they appear to be a statistical quirk, is still down 1.75% from its June peak.

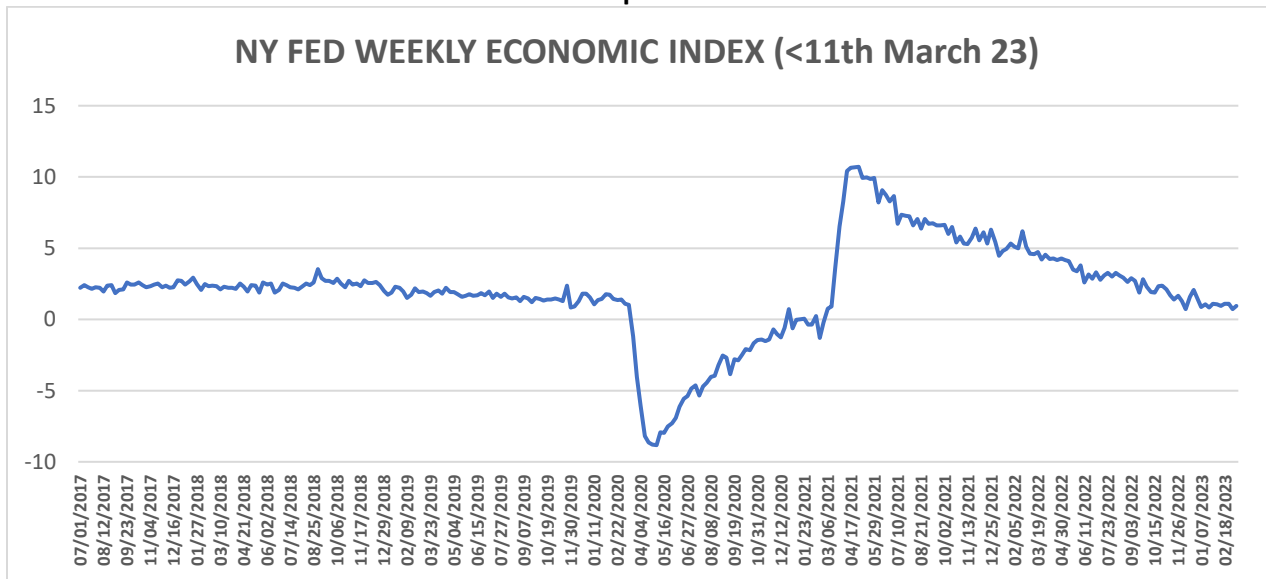
In the graph below compiled by [Adobe](#) using intelligence gathered from prices found on the internet, the fall is more pronounced. Goods prices started falling yoy in July and continued to fall in January and February to a level 1.4% below February 2022. *“February’s YoY price decline was primarily driven by sharp drops in discretionary categories including electronics (down 12.6% YoY, down 1.7% MoM), computers (down 16.4% YoY, down 1.4% MoM) and toys (down 6.5% YoY, down 0.4% MoM). Consumers also saw prices fall YoY for home goods: Appliances were down 3.8% YoY (down 1.8% MoM), while home/garden products fell 3.8% YoY (up 0.2% MoM). The furniture/bedding category fell for the first time after rising for 33 consecutive months, dropping 0.1% YoY (down 0.6% MoM).”* *“In certain categories with persistent inflation, YoY price increases have slowed in recent months. Grocery prices were up 11.4% YoY (up 0.8% MoM), down from January 2023’s 12.6% YoY increase. This marks the fifth consecutive month where YoY price increases for groceries have decelerated from September’s record high, when prices rose 14.3% YoY. In the apparel category, prices were up 5.1% YoY (up 0.3% MoM); Contrast this with February 2022, when apparel prices were up 16.7% YoY. In another category such as tools/home improvement, prices rose 6.2% YoY (flat MoM), down from January 2023’s 6.9% YoY increase and December 2022’s 8.3% YoY increase.”*

**Graph 2.**



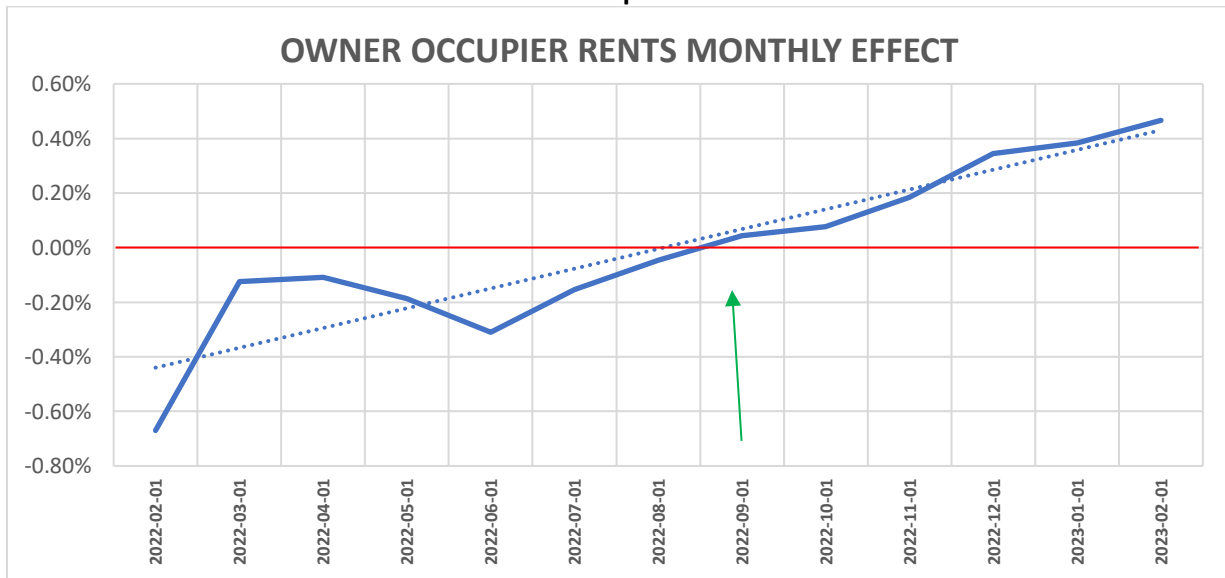
This is not surprising given the downward trend in the economy as revealed in the latest [New York FED Weekly Economic Index](#) (WEI) which takes into account retail sales and withheld taxes. Retail sales are taken from the [US Red Book sales](#) data based on 9,000 stores nationwide. March’s sales in the first half in nominal terms were only up 2.8% yoy well below the rate of inflation of 5.0%. It is important to note that in the WEI graph below, there has been a downward trend from March 2021 so that the index is now below the levels found in 2019, the year in which the economy skirted with recession.

Graph 3.



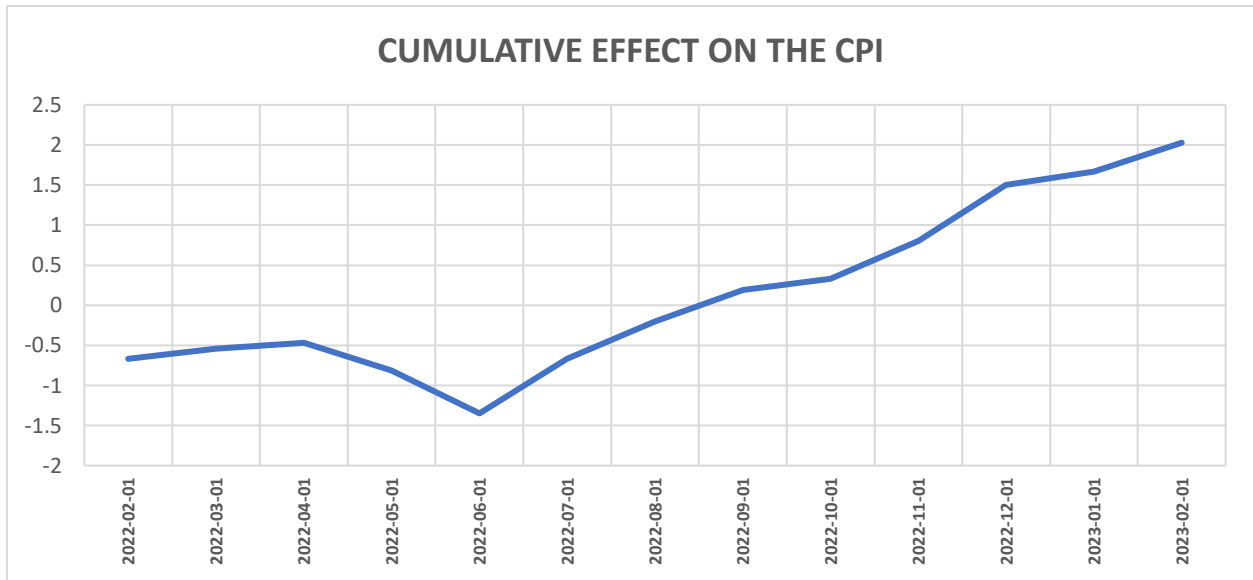
Even the CPI overstates inflation. When we adjust it for owner occupier rents which is of course a fiction, the CPI over the period from June 2022 is benign. This can be seen in the following two graphs based on FRED Table CUSR0000SEHC for owner occupier rents (spreadsheet attached). The weighting of owner occupier rents represents 23% of the CPI. We notice that in the run up to June, these rents **reduce** the upward movement of the CPI and from August they **add** to the upward movement of the CPI.

Graph 4.



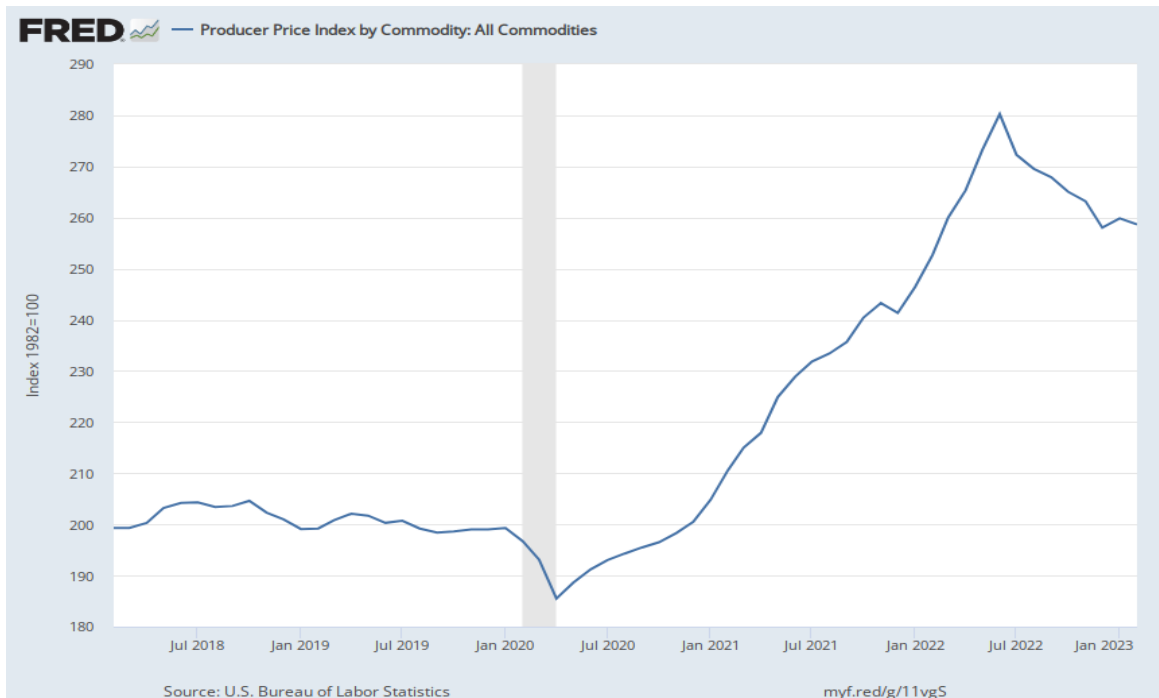
The cumulative effect of these monthly plusses or minuses can be seen in the graph below. Over the course of the year the difference between the owner occupier index of 8% and that of the CPI at 6% was 2%, but the range was 2.7%. At 23% of the CPI the overall effect on the CPI over the year was therefore 0.62%. If we take the CPI from August to February which excludes the negative part, the gap grows to 0.8% due to the fact that the CPI rose by 2.3% whereas the rent aspect rose by 5.7%. Thus since June, if we adjust for this 0.8% boost, the CPI over this period would only have grown by 1.5% or 2.0% annualised.

Graph 5.



And of course when taking into account the bull whip effect produced by softening end user sales, the Producer Price Index itself is falling sharply. On a yoy basis it is now negative.

Graph 6.



The other factor weighing on future prices is the trajectory of raw material prices other than food, particularly oil and gas. Oil which unfortunately remains the dominant energy source continues to be a barometer for the global industrial economy, and as the graph below shows, oil prices are back to pre-pandemic levels and when adjusted for the depreciation of money, they are down 10%. The same applies to [natural gas](#).

**Graph 7.**



As an aside it is worth taking a quick look at the state of the US energy industry. As far as shale oil and gas goes, the average output per well is on the decline. Unlike more traditional wells, fracked wells have a very short economic life. In 5 to 10 years the US oil patch is likely be a shadow of what it is today. No wonder the US was in such an unseemly hurry to provoke Russia into war in the Ukraine. They did so because it was the best of times to maximise profits in this industry while the oil was gushing and the blood flowing. In the meantime US oil and gas production has added to the worldwide energy glut which can no longer be disguised by musings over Chinese re-openings.

In conclusion, the evidence and trends show that actual US inflation has trended down from its peak, and if it is not in the 2% range, then it is close to it. Previously the FED was behind the curve when inflation rose (as I was) only to now find itself behind the curve as inflation falls (as I wasn't).

#### **How big are the smaller regional banks?**

Big, what they lack in size they make up in numbers. Proportionately they are more important for industry, commerce and property than *'the too big to fail'* Wall Street banks, as the table below shows. Out of total lending in these four categories, Small and Medium sized banks account for:

**Table 1.**

Commercial & Industrial Lending	50%
Residential Real Estate Lending	60%
Commercial Real Estate Lending	80%
Consumer Lending	45%

The current banking or financial crisis can be divided into two stages. Stage 1 can be defined as the excesses in fictitious capital built up over 13 years of cheap money which drove up the prices of shares, bonds and property and which led investors and lenders to take excessive risks. We are currently in the 'repricing stage' where risk-off has turned into risk-on. This is the stage most Marxist analysts are focusing on in their various articles.

Stage 2 is the banking crisis resulting from the fall in surplus value and the end of the up-phase of the business or industrial cycle. This is the more consequential stage. Many readers of Das Kapital mourn the dearth of any analysis of speculative crashes in Volume 3. Besides pointing out that industrialists resent banking antics which gives rise to speculative excesses thus damaging the prospects of industry and commerce, Marx says little on this subject. However, I am in the minority who do not believe this to be an omission. Marx's concern in Volume 3, Part 4, focuses primarily on two factors, trade credit and how the industrial cycle sets the rate of interest through alterations in the demand for loanable capital.

For Marx - trade credit - the means whereby industrial and commercial capital reduces money from the means of circulation to the means of payment is of paramount importance. What trade credit loses in terms of duration (30 to 60 days normally), it makes up in sheer volume. I have shown previously that in terms of Dollars, the **issuance** of trade credit within a calendar year vastly exceeds any other form of credit though these other forms appear to be bigger because they endure at least ten and often a hundred times longer than trade credit. But in the end it is issuance, not cumulative amounts that is decisive. A quick back-of-the-envelope calculation will show this to be true. If we examine the [intermediate inputs](#) for private industry during 2019 (line 15) it amounted to \$14.842 billion. If we were to assume that 80% of that was circulated by trade credit then the cumulative total for the year would have been \$12 trillion which was 20% more than the amount of [corporate bonds](#) outstanding at the end of 2019 (which is the debt that has caught the attention of most Marxist analysts).

But before we proceed to examine Phase 2 more concretely, we need to deal with Phase 1 first. We will begin by sketching the background to the present crisis. Total global *fictitious* asset losses, primarily bonds and shares together with their derivatives amounted to \$30 trillion in 2022, of which \$17 trillion was lost in the USA. This figures excludes property losses which were just emerging at the end of 2022 but which will become much more important in 2023. It is likely that the unrecognised losses at the end of 2022 in the financial sector amounted to \$1.8 trillion, a fraction of which has now been recouped given the rise in share prices and bond prices so far this year.

Such losses hurt not only investors but banks as well, and especially, hedge funds and private equity whose finances remain hidden in the unregulated murk. I will not repeat what has been said on other sites about how the losses in bank assets erodes the capital bases of the banks often requiring an infusion of new capital to ensure liquidity. I will not repeat that *Silicon Valley Bank* failed because it failed to rotate out of long term bonds into shorter dated treasuries timeously as other banks did, thus saddling the bank with extraordinary losses. What I will do is echo Michael Hudson's observations of the collusion between the Regulatory Authorities and the Banks allowing them to hide their losses. Here is the irony. Had the banks been forced to mark their assets to market, this would have reduced their ability to lend. This contraction in lending would have curbed the economy. This brake would have made the raising of interest rates by the FED more effective. Because this lending discipline did not take place, the FED was forced to raise rates higher to have an effect. The higher the rates the more banking assets were impaired. Thus these regulatory fraudsters, by allowing the banks to continue lending as before, ended up damaging the banks more than would have been the case, had they acted in a timely and proprietary manner. Ahh, the dementia of greed; the capitalists forget everything and learn nothing.

What we saw last week was a flight to safety. Investors and depositors fled from the banks to the safety of treasuries because the FED/Treasury is too big to fail, especially when they can print their way out of jail. As a result of these purchases of 6-month and 2-year paper, prices were driven up and the yields

down. The fall in the 2 year yield was similar to the fall in yield before the 2008 financial crash when investors bailed out of mortgage securities and into treasuries. It is important to note that outside a financial emergency, an inversion occurs when investors sell short to buy long. In this case however, both shorts and longs fell together indicating this did not represent selling, but the buying of short dated treasuries (6 – 24 month paper) alongside long dated paper. As a result of its greater fall, the inversion between 10-year and two year yields contracted from 1.08% (the highest since 1981) to around 0.5% currently. However, any inversion still indicates recessionary conditions because this inversion represents investor pessimism over the short term outlook for the economy.

Clearly given the magnitude of the decade old rise in share ‘values’ and property, courtesy of Quantitative Easing repressing interest rates, the ‘repricing’ of these assets still has some way to go. How far they have to fall depends entirely on the industrial cycle and the production of surplus value.

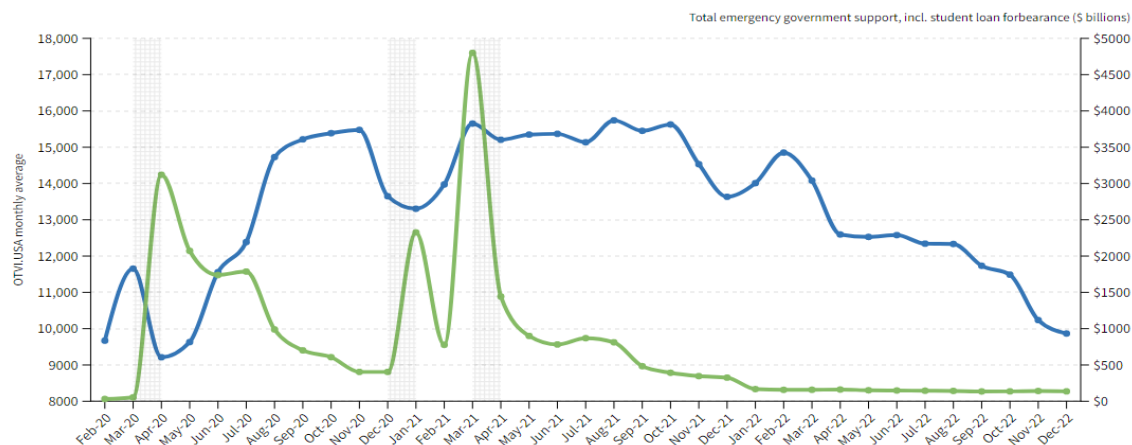
It is the combination of falling profits and rising interest rates which cuts the knot holding credit and the economy together. This is [FactSet’s](#) estimate for profits and revenue in the first half of this year. *“For the first quarter, S&P 500 companies are expected to report a year-over-year earnings decline of -6.1% and revenue growth of 1.9%. For Q2 2023, analysts are projecting an earnings decline of -3.8% and revenue growth of <0.1%”* In my estimation even this downbeat profit outlook is far too rosy given what is transpiring in March. If September 2022 was the pivotal month for the world economy, the time when the world economy stopped expanding and started contracting, then March represents a further change in gear downward.

If FactSet’s prognosis for revenue is remotely correct, this represents recessionary conditions. A revenue growth per share of below 0.1% to a maximum of 1.9% means a substantial volume contraction in global sales over these 6 months. This is confirmed by the movement in freight volumes which can be seen in this interesting graph which shows the association between Covid funds and trucking volumes. Already by the end of 2022, trucking volumes had fallen below pre-pandemic levels and have continued to fall. The issues of bank insolvencies will only accelerate that trend as we are about to see.

**Graph 8.**

### How Pandemic Aid Affected U.S. Truckload Volume

Total emergency government support, incl. student loan forbearance, compared to monthly averages of SONAR's OTVI.USA.

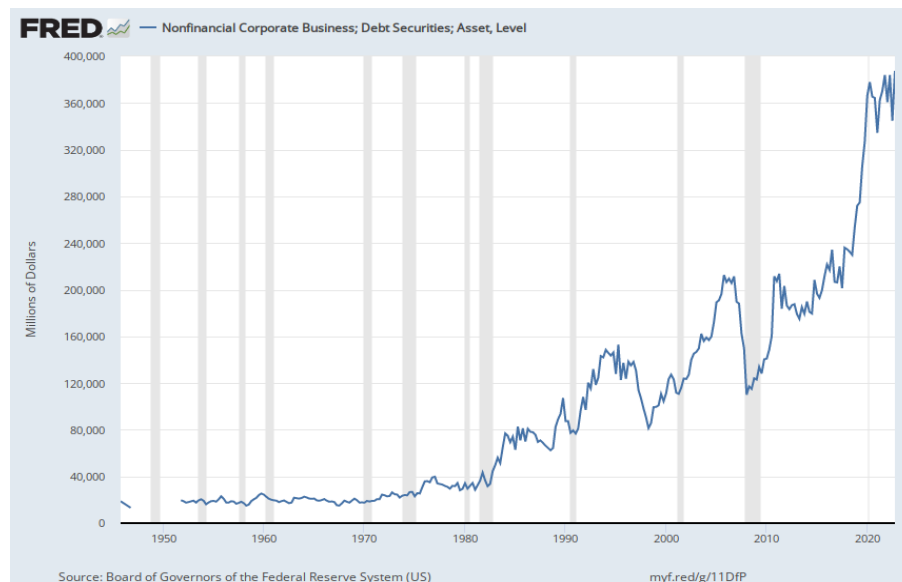


Source: U.S. Bureau of Economic Analysis and FreightWaves SONAR  
NOTE: Shaded areas indicate when COVID-19 stimulus measures were signed into law.

**FREIGHTWAVES**  
RESEARCH

Furthermore, when we ignore fictitious assets and concentrate on produced or actual assets and debts, we see by how much leverage has increased in the non-financial corporate sector. Actual indebtedness has soared, something which cannot be seen when we measure debt to equity ratios where the opposite appear to have happened because over the last ten years, excluding 2022, share prices rose sharply.

**Graph 9.**



Stage 2. From write-downs to write-offs, or from *credit-crunches* to *credit-tightening* and so on to Stage 2. Normally if interest rates were left to market forces as the Austrians would like it, Stage 2 would precede Stage 1, because trade credit is more sensitive to fluctuations in interest rates and profit rates, than are speculative assets. But we live in abnormal times and so the order has been reversed.

Generally, the biggest demand for loan capital from banks is used to finance fixed and circulating capital. When the rate of profit is rising, in what is called the phase of *rising prosperity* which also happens to be the longest phase in traditional business cycles, the amount of investment which cannot be financed by growing internal funds, will set the demand for loans funded from external sources - the banks and the bond markets.

The funding of circulating capital is peculiar. During the upphase when production swells, the need for additional working capital also grows to pay for more inputs and workers. But it also rises at the end of the upphase when production begins to contract. This is because of the slowdown in the circulation of capital. What took ten days to turn into cash may now require 20 days, which means an additional 10 days of working capital is needed even when spending on workers and inputs is pruned. More money is needed and that is what bank credit provides. Bank credit is always temporary money because it has to be repaid.

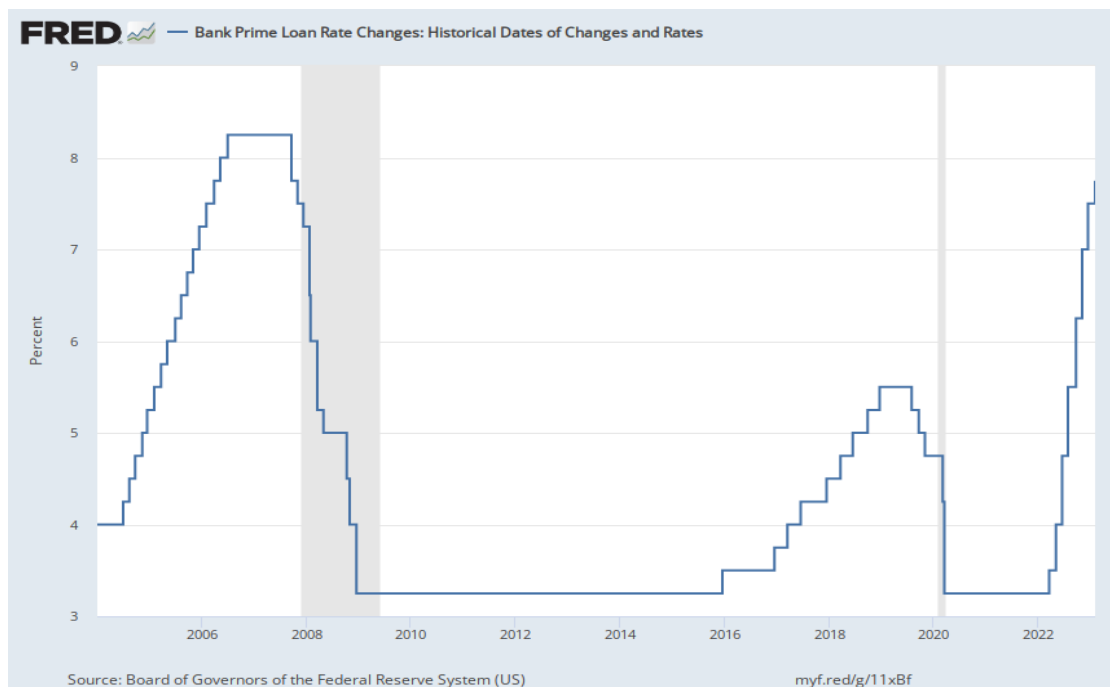
This is the moment of maximum stress for trade credit. Sellers no longer trust buyers' ability to pay off their outstanding credit on due date. They are therefore reluctant to extend credit. Only Cash on Delivery (COD) will now suffice. This makes a bad situation critical. Trade credit lubricates the circulation of capital and when it dries up the resulting friction burns re-production. At the end of 2015 and in 2019, cheap money in the form of repressed interest rates (QE) prevented trade credit shattering. The hunt for yield



allowed weaker companies to continue to raise funds which their internal profits were unlikely to ever cover. However times have changed. In a **risk-on** environment these borrowers have to go cap in hand to their banks begging for short term credit only to leave sad faced through either being rejected or being punished with punitive interest rates.

Unlike 2015 or 2019 lenders are not rushing to lend. The hunt for yield is over. Risk is being priced in. Even if the FED decides to freeze interest rates at its next meeting, or to raise them by only 0.25%, and then indicate a top has been reached, the damage will have been inflicted and be irreversible in the short term. With the moving average rate of inflation currently at around 2% and with prime overdraft rates, the shortest form of bank credit, close to 8%, trade credit is becoming unaffordable.

**Graph 9.**



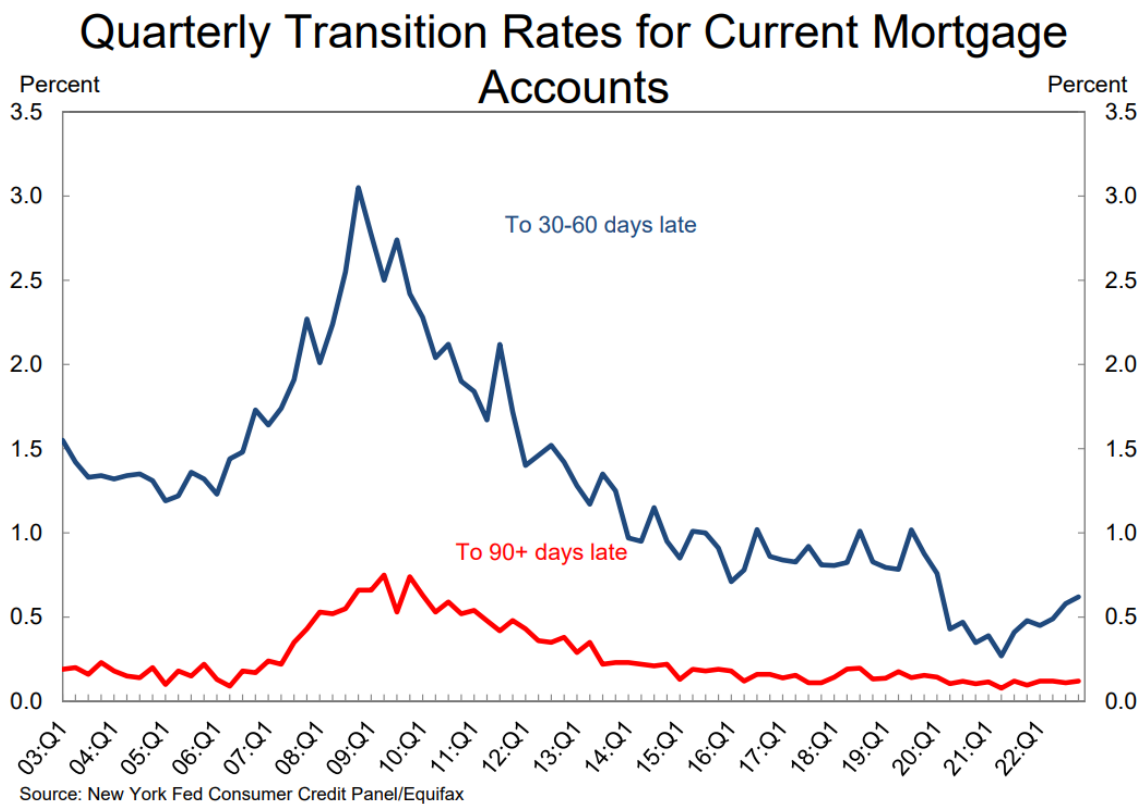
I have used overdrafts, as the interest rates charged for this form of bank credit tends to respond quicker to conditions in industry, commerce and property. In addition, the [issuance of commercial paper](#), that is bank credit with a typical maturity of under 90 days for lower rated customers has increased by 20% in the first three months of this year compared to 2022. This is the phenomenon found at the end of the industrial cycle when desperate cash starved businesses approach banks attempting to discount their bills of exchange in return for cash, even if the rate of interest is against them.

Smaller banks were issuers of 50% of Commercial and Industrial loans which are bridging loans normally lasting up to 2 years and are considered more risky than commercial paper. Their issuance fell by 5.9% in February and that decline is likely to have continued into March. It is likely that a higher percentage of these loans will have to be written off, and it is likely that lending requirements for these bridging loans will have been tightened as well.

Turning to the consumer. The graph below covering Q4 2022 already shows the turn in the consumer lending environment where smaller banks have a 45% share. Taken from the [NY FED](#) Survey on Household

Finances, it shows the trend in delinquencies is now upwards. The same applies to Credit Cards and Auto Loans where consumers are now maxed out. On Tuesday the NY FED announced that the rejection rate for Auto Loans had quadrupled yoy to 9.1% of all auto loans or 1 in 10 applications. This is no surprise, the unaffordability index for car purchases is the highest this century. I said last year that the auto industry will rue the day they jacked up car prices under the cover of chip shortages. They will pay for this profit gouging for years to come.

**Graph 10.**



I have left the worst to last. Perhaps the most worrying aspect is commercial property loans particularly for office space where smaller banks hold 80% of outstanding mortgages. With the growing redundancies being announced in the larger corporations (mainly office workers), with work from home still prevalent, and with ChatGPT attacking white collar work, the outlook for office space is dire. Once the write offs appear on lenders balance sheets this will further impair their capacity to lend. Asked in his Press Briefing after the FOMC meeting whether he was concerned about smaller bank exposure to the risks in Commercial Property, Powell said he was relaxed about these risks because the banks were well capitalized.

Although residential property is less problematic than commercial property at the moment, it is still highly risky for the smaller banks who hold three out of every five mortgages. The residential property market is even more sensitive to mortgage rates. With the 10-year yield having reached its probable zenith at around 3.5% (having fallen from above 4.2%), the 30-year mortgage has followed suite falling by 0.5% as well. It is still too early to say whether or not this fall will support the housing market which has been in retreat. [Redfin](#), one of the largest realtors in the USA provides the most up to date housing information.

A fortnight ago, it's pending home sales were still down 30% yoy while the median sale price in February was \$387K versus \$429K in June. This is a combination of falling house prices as well as a shift to smaller and cheaper properties due to affordability issues. While there is an argument that full employment will support the housing market, this is not true. The sacking by High Tech corporations, the banks and others concentrated amongst the more highly paid office workers, will reduce the pool of workers able to afford their own homes. The employment of lower paid and part-time workers will not. To compensate for the announced loss over the last year of 300,000 better paid jobs in High Tech alone, the equivalent of 800,000 more poorly paid workers need to be employed.

As the industrial cycle turns as has already occurred, the amount of layoffs will rise sharply. Capitalists can do very little about their selling prices, even Apple. They can only control their cost prices, and the biggest element of that is wages. So as their profit margins are squeezed which is happening now they have to turn on their workers in order to cut wages. And they have to do so with increasing savagery, because their ability to borrow more money has now been undermined by risk-on conditions together with impaired bank balance sheets.

### **The FOMC raises rates to a band between 4.75 to 5.0%**

As the markets expected after the recent bank failures, the FED raised rates by only 0.25%. The fact that they actively discussed a pause is more important than future projections and dot plots. It indicates that the FED is done raising rates. The reason they did not pause was that the FED believes the economy is growing more strongly than expected with the labour market tighter than expected. Once more the FOMC seems to be suffering from SUD, Seasonal Adjustment Disorder.

It is very unusual for the FED rate to be above market rates for Treasuries. At the time of writing the 2-year yield is 3.95% while the 10-year yield is 3.5%, or 1% and 1.5% below the FED rate respectively. This occurs only during a recessionary period which Powell has ruled out. It really does show the financial system is broken because of all the previous excesses.

### **Conclusion: credit crunch or merely credit tightening?**

M2 (the most common measure of the supply of money) has fallen by around \$300 billion yoy to January 2023. This is roughly equal to the FED's Quantitative Tightening. But this is only one side of the coin. The annual reduction in the Federal Deficit year on year was \$1,004, thus the FED injected less money into the economy compared to the previous calendar year. Last but not least, looking at the growth in nominal GDP in terms of final sales minus the increase in circulation yields \$530 billion. That is the increase in unspent nominal revenue. The net effect is  $+530 - (300 + 1004) = -\$774$  billion. Which is why total deposits other than long term deposits fell by \$780 billion over the year and the money supply contracted. Here we are not discussing absolute numbers but relative changes between periods.

When we talk about the money supply we cannot ignore its biggest component which is unspent revenues; what I call legacy value. It traditionally represents 90 – 92% of M2 and deposits. The remaining balance is made up of deposited bank credits (temporary money) and budget deficits (permanent money). There is also the flows into and out of the country, and the flows into and out of the speculative arenas.

When accounting for the above fall in total short term deposits we noted that the addition to the money supply from unspent revenues amounted to only \$530 billion. This was insufficient to offset the other elements. Once we understand the breakdown of the sources of M2, we recognise that the biggest

influence on whether or not financial conditions are tightening or not, is the influence of national income, and changes to national income as well as how that income is spent. A fall in real income, or more precisely unspent revenues, will automatically reduce the money supply everything else being equal. The Bank of International Settlements quoted by [Michael Roberts in an earlier post](#) on his site seems to instinctively grasp this: *"it is income, not money, that causes spending to increase, with the evolution of money balances acting as a signal."* Actually it is income that drives both money and spending.

In summation, for the time being the FED and the US Treasury have won the first battle in a war they will lose. They have avoided a credit crunch, but its very appearance has done what the FED has not been able to do so far, and that is to sharply tighten up on lending. This means that bad debts can no longer be rolled over. For this reason history will look back to March as the moment when tightening caused the economy to decelerate faster. And it will be this aggravated deceleration, which by precipitating a surge in bad debts, which when added to the repricing of assets, will collectively be too much for the banking system to bear even with the help of the FED crutch.

As I said in my inaugural post this year, 2023 will be the year of the financial crashes.

Brian Green, 22<sup>nd</sup> March 2023.