

HALF WAY POINT BETWEEN THE ELECTION AND THE INAUGURATION. Are we reaching an inflection point?

Those whom the profit motive seeks to destroy are first driven mad by greed. History is likely to view the immediate period after Trump's election, at least from the financial point of view, as a ridiculous period, one where unbridled optimism substituted itself for analysis, where expectations disregarded impediments. As such it is a mark of desperation, a capitalist class long stuck in a stagnant economy grasping for salvation. That they should reach for salvation through a political buffoon like Trump, is very telling. The key question is this: Will the markets be rocked to their foundation when investors realise that the economy cannot escape intact from the regime of low interest? The answer is yes and we may have an answer by January.

It started so well for Mr Trump. All it took was a conciliatory speech on the morning after the election to transform a 7% plunge in share futures into a 6% rise in actual share prices within 4 weeks. The longest losing streak in share prices since 1980 had given way to one of the strongest pick up in share prices. The result is that share prices for the S&P 500 at the time of writing are up 10.5% this year yielding a trailing P/E of 28 (and one likely to reach 30 by year end).

Friday the 11th December marks the mid-point between election and inauguration. It is useful to divide this interim period into two - the period up to the 11th December and the period from there to the 20th January. Up to the 11th December optimism was unbridled and the market seemed unstoppable. The week beginning Monday the 12th however brought some sobriety to the conversation. The data releases all disappointed. Industrial production, retail sales, housing starts and the CASS freight index all fell or did not rise significantly. In effect, they collectively reversed all the gains recorded in October. Although it is premature to be categorical, for that we need data for December, it appears that September/October, far from setting a new trend, were in fact an aberration. If GM, Ford and Boeing are anything to go by, their recent announcements of cut backs to production due to falling sales and orders suggests the downward trend is re-establishing itself.

November has returned the economy back to mediocre. The result is that the Atlanta FED's Now forecast (cited in *Nowcast, GDP Now Diverges Widely Again: What Happened?* Mish Talk) varies between 1.5% to 2.5% for real GDP growth in the fourth quarter. All that is missing is the data for December. The gap between the low and high estimate is testimony to concern about December's data. If December follows November, it is safe to assume that GDP growth will be closer to 1.5% than 2.5%. That will yield annual growth of 1.6-1.7%. Annual GDP figures are not seasonally adjusted, but in this case, given that 2016 is a leap year, 0.35% needs to be deducted from growth when comparing this year to 2015. Therefore, adjusting for the extra day in 2016, this produces a real growth rate of only 1.2%.

Real growth of 1.2% is within the band of growth set since the end of 2014. If from this figure, we deduct the fiscal stimulus of 0.7% (increase in the annual deficit) this reduces GDP growth to 0.5%, or down into the basement of duplication and imputation. In other words, little or no growth. And yet this has not stopped the FED from raising interest rates this December and projecting three more increases in 2017, all based on their assumption that the economy is strengthening and this strengthening could accelerate under a Trump presidency.

The rate rise was forced upon the FED by the recent spike in market rates, but their declaration for three further increases in 2017 was not. It is extraordinary, because the recent effect of the rise in 10 year treasuries to 2.5% and 30 year mortgages to 4.25% has yet to be measured. If November's data is a result of the rise in interest rates, then it is probable that December's data will similarly be effected. And if it is, then the revival of the US economy depends on interest rates falling back not going up. That is why January, the month that Trump moves from golden taps to chrome taps, is going to be such a crucial month.

At this point the trap door is sprung under Trump's master economic plan. If it turns out that the first significant rise in interest rates for two years was sufficient to undermine the economy, then his economic plans amount to a tower of sand. The reason being that his tax cutting plans will be interest rate positive due to the hike in the federal deficit. On the spend side, his "massive" (really modest) spending on infrastructure will be swept aside by the fall in output higher interest rates will bring about. The evidence is already in. Private Residential spending on an annualised basis, according to the most recent Census Bureau Release, amounts to around \$450 billion. It therefore requires only a 20% fall in residential spending to wipe out the annual \$100 billion infrastructural spend Trump is trumpeting. Such a fall is not far-fetched, it occurred in November when new housing starts fell 19% month on month. December will reveal if this fall was seasonal or a product of rising interest rates.

The role of the central bank.

Central banks are essential to the functioning of the capitalist economy. They act as the lender of the last resort and are called upon whenever financial stress threatens to paralyse the economic system.

Production based on private ownership and for private gain divides capitalist producers. They are separated from each other by money, by the need to convert their product into money enabling them to purchase each other's products. A failure to convert their product into money, the absence of a sale, renders it valueless and constitutes a loss of their capital.

It is in this light that credit must be seen for what it is, the medium to circumvent money, to reduce the use of money to a minimum, to avoid the gatekeeper – the money lender and his demand for interest. Credit is the attempt to go beyond the confines of private property. By means of credit taken and credit given, private propertied producers and distributors reach across the chasm separating them. The seller produces his own market by giving the buyer the means to purchase his product, elevating himself in the process to creditor. In production and wholesale credit dominates with money relegated to clearing debts on due date.

Credit lubricates circulation driving production upwards and onwards, speeding it up. Without credit, capitalism would lose its dynamism. The more developed capitalism, the more sophisticated is its credit system. However, credit cannot escape its shadow, money, forever. Most debt requires money to extinguish it. At some point debts fall due and if there is no money to clear these debts all the connected obligations start falling apart and the carefully crafted chain of credit shatters. Now money is king (Marx) and credit to be avoided. The requirement for cash on delivery immediately creates a shortage of money.

This event does not occur simply because credit is overextended, though the degree of over-extension will determine the severity of the resulting crisis. It occurs because of the collapse in profitability, the reasons for which are not directly connected to credit even if credit caused these conditions to mature more quickly by accelerating the pace of capital accumulation. It is this loss of profit that robs the debtor of his ability to meet his obligations. When this becomes generalised a financial crisis ensues.

It is at this point that a minority of over-extended corporations and banks become both illiquid and insolvent, while others become illiquid but not necessarily insolvent. Here the role of the central banks becomes crucial. As the lender of last resort, they alone can inject liquidity into the markets to keep the solvent firms functioning and to dethrone money. Here an analogy will suffice. When the body is bruised, the immediate application of ice prevents the trauma from moving across from the damaged tissue into healthy tissue. The bruise is minimised. In the case of the central banks, they are the ice.

The primary role of central banks is to be reactive not proactive. When they become proactive, as the FED has become under its compulsory mandate: “to foster maximum employment and price stability” it ends up mired in absurdities. Its record speaks for itself. In December 2015, the FED’s FOMC forecast that the appropriate rate for Federal Funds at the end of 2016 would be 1.375%, implying at least four rate hikes during 2016. It also projected GDP growth would rise to 2.4% for 2016. These were quietly shelved a few months later when the world economic outlook in the first half of 2016 did not adhere to the FED plan. In the end, the FED only hiked once in 2016 yielding an effective Fed Funds rate that is only half the originally projected 1.375%.

Similarly, in December 2016, having raised the Fed’s fund rate by another 0.25%, the FED indicated a further 3 rate rises in 2017. The FED was forced into a rate rise by the spike in interest rates resulting from the Trump effect. What it was not forced to do was to project three rate rises in 2017 in an environment where it is not yet clear whether the 10year treasury yield can keep its head above 2.5%, as the bad news rolls in.

It is one of the myths of recent years that the FED and other central banks are responsible for interest rates being so low for so long. Nothing could be further from the truth. It has been the glut of unspent capital accruing around the world, specifically in the vaults of the multi-nationals and global banks that is primary source low interest rates. Interest rates represent the interaction of the demand for money-capital on the one side and its supply on the other. Since 1996 and the surge in globalisation, the gap between the two has grown because of the growth in the supply of potential money-capital. Only recently have interest rates begun to edge up, not because the demand for capital has increased, but because its supply has diminished with the absolute fall in the mass of worldwide profits compared to its highpoint in 2014.

The real problem with a pro-active FED struggling under a compulsory mandate is that it ends up, as Keynes would have said, pushing on a piece of string during a downturn and it may be added then hanging from it during the closing stages of the upturn. In effect its twin mandates dictate that the FED should moderate the business cycle at its opposite ends, warming it up with low rates on the decline and cooling it down with higher rates on the upswing.

In the first instance, low interest rates during a downturn are not the result of a shortage of monetary supply but arises from the absence of demand, because investment is subdued or falling. And investment remains subdued because of a crisis of profitability and not interest rates. Hence the policies of the FED have little impact, as shown by the diminished gap between short and long term interest rates over which the FED has little control. Indeed, the projection of FED fund rates in 2017 is predicated on the 10year treasury yield remaining at 2.6%. In that sense the FED is playing catch up. Wall Street’s mantra “don’t fight the FED” is the wrong way around, it is the FED that can’t buck the markets. Everything the FED does is predicated on market conditions, conditions dictated to by profit rates and only secondarily by interest rates.

More crucial is the role of the FED and other central banks at the top end of the business cycle – the period when investment is at its strongest, where credit is rapidly expanding and prices spiking

including asset prices. Here the FED can have an effect by tightening liquidity in the market. This can slow down the rise in production and prices. However, the same policy can have two opposing effects. If it coincides with the continuing rise in profitability it can restrain production and elongate the business cycle by slowing it down. However, where it coincides with a falling rate of profit, the natural brake on any cycle of accumulation, its effect will be to precipitate a more immediate credit crisis and to deepen it. The effect on production is then amplified.

This happened in the early 1980s and 1990s since when the FED has been more cautious in its approach which helps explain 2008. It also explains the differences of opinion on the current FOMC board as whether or not to run the economy hotter before raising interest rates. Unfortunately, this caution has not extended to its recent pronouncements. By January 2017 the same conditions that prevailed in early 2016 may repeat itself once more. The strong dollar is disrupting the world economy and creating headwinds for US exporters. Higher interest rates are inhibiting credit in crucial rate sensitive industries like autos and housing. It is exacerbating the fiscal deficit.

The December 2015 pronouncements by the FED were presumptive, the newest may turn out to be farcical. The clockwork monthly meetings requiring pronouncements would better be replaced by meetings held only when changed market conditions warrant them. That way the temptation to be pro-active would be removed.