THE IMPACT OF THE RISE IN THE RATE OF INTEREST COMPOUNDED BY THE RISE IN THE RATE OF STUPID on the US and world economy.

The world is entering the white-water phase of history once again, when events move ever more rapidly, dangerous rocks grow larger and more frequent, requiring greater political skill to navigate these treacherous waters.

The last month has been hectic. Trump has not disappointed. The first salvoes of what is still a limp trade war have been fired and Trump has surrounded himself with neo-con hawks. Trump's dysfunctional personality mirrors a dysfunctional society, and despite his critics, he does personify the needs of a declining imperial economy, one that used to dominate the world economy. In contrast, to Trump's whine that everyone has taken advantage of US generosity, it is the US that has pillaged the world economy since WW11. But then, historical accuracy was never going to be Trump's strongest suites.

If Trump seeks to protect the rump of his steel and aluminium industry, he does so because he recognises that the US cannot go to war without steel and aluminium. If he adds to the spending on the defence budget, he does so to compensate for a declining industrial base by focusing on where the US still leads, technology. In 1942, at the time of Pearl Harbour, the US industrial base was three times larger than that of Japan. Today, the roles are reversed: China's industrial base is three times larger than that of the US. It is for this reason that the next recession is so full of peril.

Trump was the product of the decline of US imperialism. Far from making the US great again, his policies will in fact hasten the decline. The business-friendly tax give-aways in December which delighted the capitalist class and their corporations, was unaffordable. The recent $1.3 trillion budget, was unaffordable. The steady rate increase by the FED, is unaffordable. The resulting rise in the key 10-year interest rate to 2.8% is the stalling speed for the economy adjusted for inflation, and the point at which the cockpit alarm sounds: "*pull up, interest rate terrain ahead, pull up!"*

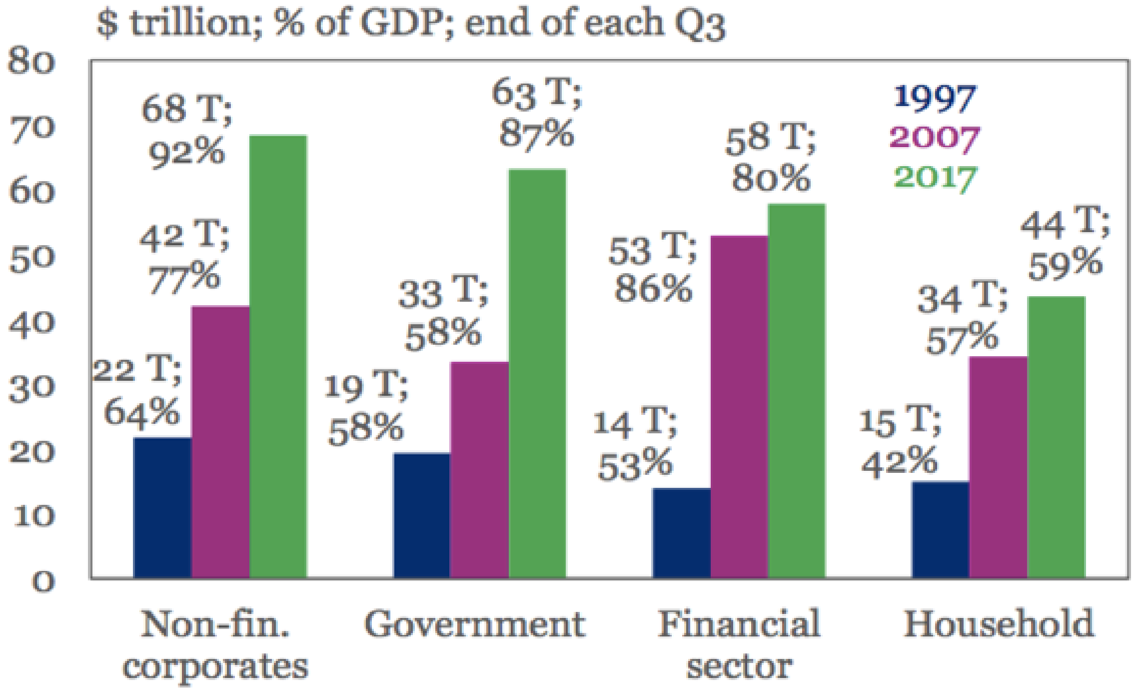
The question of methodology.

Putting the rate of interest before the rate of profit is to put the cart before the horse. Except that these are not normal times. As I have written previously, I hypothesised that what we are dealing with since 2008, is not one but two industrial cycles, with the former ending in the last quarter of 2015. (Like Marx I prefer the use of the term, industrial cycle to the business cycle as it is more exact, recording the fact it is the changes in production including investment that determines the phase of the cycle.) However, the aberrant behaviour of interest rates leading up to and during the pseudo recession which occurred in the final quarter of 2015 and the first quarter of 2016, ensured that little actual capital and debt was purged from the system.

This accounted inter-alia for the weak and elongated period of rising animation (Marx's definition) beginning in mid-2016 ensuring that to this day, the mass of profits in real terms, as we shall see, has not eclipsed its 2014 peak. However, by the second half of 2017 the world economy did speed up sufficient to pose the question as to whether the phase of rising animation was transiting to the phase of prosperity (Marx's definition). The phase of prosperity is not only characterised by a significant acceleration in production providing an impulse to profits, but also by rising interest rates. It is also marked by an acceleration in the turnover of capital.

It is the level of debt, debt that was not purged in 2015 and since added to, that has made the world economy so sensitive to the rising rates of interest. The rise in interest rates can and will block this transition. The growth in world debt is shown in Graph 1 below. The **Blue Graph** is Q3 2000, the **Purple Graph** is Q3 2008 and the **Green Graph** is Q3 2017 since when debt has increased significantly.

Graph 1.



(Source: Institute of International Finance [IIF], global debt as reported on *Seeking Alpha.)*

Only the financial sector has deleveraged, falling from 86% of GDP to 80%. In contradistinction the leverage of non-financial corporations has shot up from 77% to 92%, an annual rate commensurate with the period 2000 – 2008 when real investment and production was growing much faster. It is this indebtedness which means current rates of interest are more sensitive to debt than previously. It is for this reason that the stalling speed set out by Wall Street Analysts, at 3.5%, is too high.

The FED's dot plot intervention has seen the rapid rise in short term interest rates (up to 2 years). The result is that the gap between 2 and 10-year yields has shrunk to around 0.5%. Normally such a thin margin is interpreted as a slowing economy, but in this case the analysts attribute it to the activity of the FED, or more precisely the issuance of significant amounts of short term debt coupled to the FED's impending sale of its Q.E. holdings which comprises longer term notes. Whatever the case, the 0.5% margin is bound to eat into banking profits much of which is based on borrowing short and lending long. Additionally, the spike in two-year rates has fed into prime overdraft rates which now stand at 4.5% and interbank rates at 2.7% (to which $350 trillion, yes, $350 trillion of bets are based). The last time inter-bank rates stood at nearly 3% was in the period preceding the crash in 2008.

The FED is ill advised to plot higher interest rates over the next three years. While its hands are largely tied by the absurd fiscal policies of the Trump administration, what it has not factored in is the effect that higher interest rates will have on consumption and the stock markets. It will not take excessive moves in both to drown the effect of the tax give-aways and higher government spending.

Already we have seen the effect of these higher interest rates on big ticket sales such as housing and motor cars in the US. It is also the reason why GDP growth for the First Quarter is not accelerating to near 5% as was expected in January but is decelerating to 2%. It is not the threat of trade war that is causing this, but the underlying change in monetary conditions which makes the economy vulnerable to political shocks.

The 20% fall in the ten-year rate from March 2017 will not be repeated, despite the rapid cooling of the economy. That avenue has been blocked by the rising deficit driven by falling corporate taxes, rising expenditure and larger interest payments. The federal government is on course to increase borrowing by $500 billion over the next twelve months causing the deficit to rise from 3.5% of GDP to 5% based on GDP growth of at least 2.5%. Anything lower will see the deficit rising further making it one of the highest peace time deficits ever, a fitting tribute to the mess Trump and his Republicans will leave behind, confirming Lenin's view that it is the fools of the capitalist class who are the best recruiting sergeant-majors for revolution.

One of the corner stones of the Republican Party, of which Trump is a nominal member, is prudent fiscal management. As always, this prudency has turned into a phantasy, deployed only to tease the Democratic Party over their mismanagement of the economy. In fact, the worser managers of the capitalist economy has always been the Republican Party, and when the damage becomes clear in the next couple of years, it will far exceed the damage Kim Jong-un could ever wreak on the United States. Far from reversing the decline in the economy, it will hasten it. But then what could one expect from the political product of this decline, Mr Trump himself.

The FANG has gone BANG.

In previous postings I wrote that the business models of most of the FANG group of corporations, which were the main driver of the stock exchange, were beginning to unravel. Their dependency on advertising revenue was unsustainable. Advertisers such as Procter and Gamble were beginning to discover that users of these platforms, instead of engaging with their focused adverts, resented their intrusion.

These tech giants were always vulnerable to the fiasco of Cambridge Analytica which marks a seminal moment in their decline. Cambridge Analytica was a public relations disaster waiting to happen. It was their dependency on advertising revenue that forced Facebook, Google and others to mine personal data for profit, and to sell the results to data brokers. The profitable purpose of their machine learning was commercial surveillance. But it turned out this information had not only a commercial value, but a political value as well, which was exploited by Cambridge Analytica.

It was not so much the Russians who were mining and using this information, but good old public-school boys speaking English. As always, the spies were within not without. It may very well be the case that all the attention directed at the Russian was simply mis-direction, a cover for what was being done at home. Whatever the case, the Cambridge Analytica revelations have accelerated the unravelling of the wild-west business models of these corporations, which are now attracting government regulation, repulsing users who will be more cautious with their personal information, and further undermining the value of advertising on these platforms.

It could also lead to these platforms being forced to offer the option of pay-to-use or pay-to-view services to reduce their dependency on advertising and data mining. It is likely is that the free to use model that users once enjoyed, is more or less dead. What is highly likely is that the FANG corporations which led the markets into the stratosphere will now lead them down into the abyss. On the 27th March, FANG shares lost 5.6%, the most in one day since the series was compiled.

But the rot is not limited to the platforms depending on advertising, it includes the US champion itself - Apple. Financial Analysts such as Goldman Sachs have gone cold on their shares as iPhone sales fall. Apple is dependent on iPhone sales, and while it has not yet suffered a Nokia moment, it is clear that smartphone sales are stuttering and high-end phones wilting. The improvement in mid-priced smartphones both in terms of performance and looks, is undermining the case for expensive high-end phones that offer imperceptible improvements. The question is whether Apple can transition to lower priced phones or whether it will persevere with its premium products when there is no longer a marketing case for them. Whatever it decides, it will no longer earn the profits investors took for granted and which was the basis for the stellar rise in its share price.

The key role of profits.

The February correction, followed a month later by the violent oscillations in the week beginning 16th March, was but an appetiser for what is to come. In that week, US indexes lost at least 5%, the worst week since 2016. On the Monday, the Dow Jones lost 1000 points, <u>twice</u>, which is unprecedented. It appeared that the markets were trying to make up for the prior two years of low volatility.

This tug of war behind the oscillations is not due to unruly algorithms but to the opposing influences of the technicians versus the fundamentalists. The former are guided by their graphs, trends and past history which leads them to opinion that the market is old in the tooth. The fundamentalists, however point to the real economy, which they believe to be buoyant and productive of profit. Until the fundamentalists become convinced of the opposite, that the economy is deflating and that profits are contracting, they will not concede, and the markets will have a degree of resilience.

The real crash will occur only when the economy can no longer provide the profits needed to shore up the expensive markets. Like the law, profits have to not only fall, but be seen to have fallen. Profits in the last quarter was an example of two opposing stories. *FactSet* which provides the most comprehensive analysis of the per share earnings for the S&P 500 registered a 17% increase in annual profits. In contrast, the BEA reported that total corporate profits fell 6% (quoted by Bloomberg and taken from line 42, BEA Table 1.14 which was released 28th March). This 23% discrepancy is analysed below the graphs.

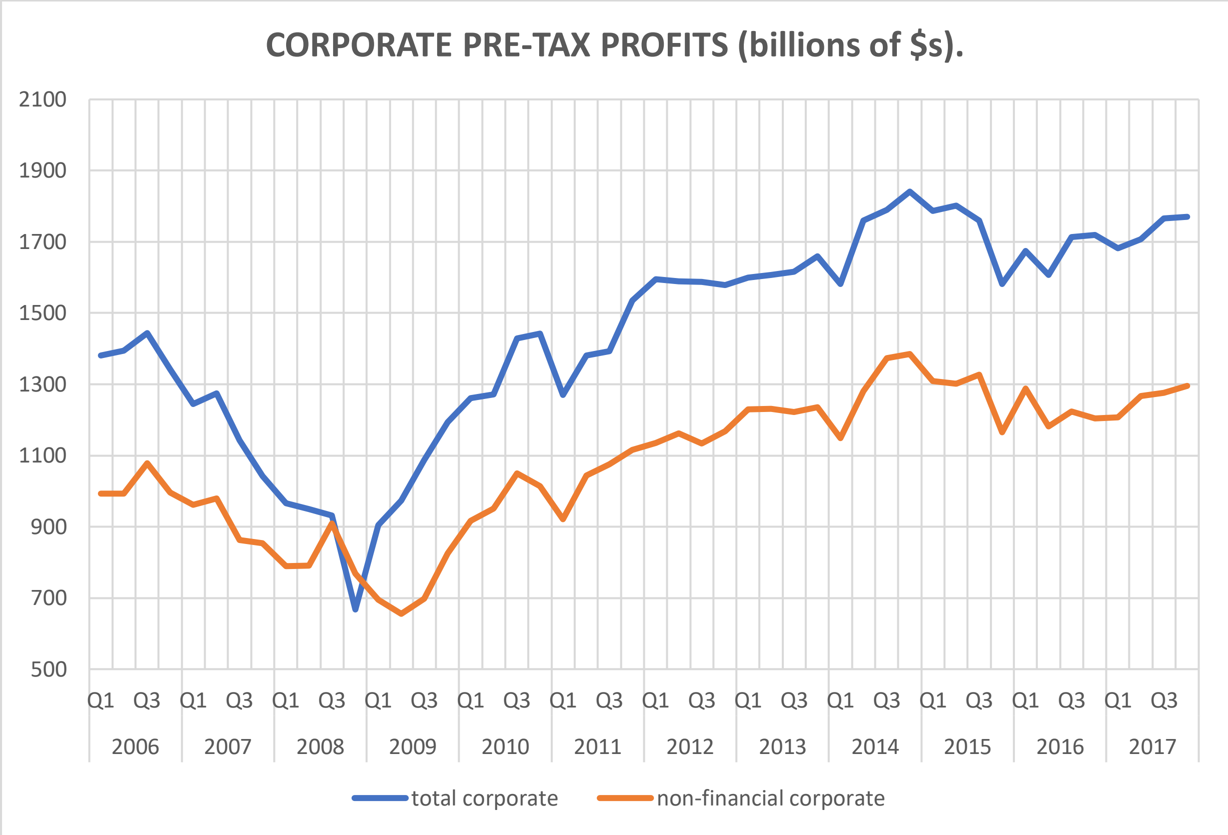
I have stated previously that I do not put too much credence in the fourth quarter profit figure because it is confounded by Trump's December tax giveaway which allowed corporations, especially the large ones, to write off tens of billions of accumulated tax credits. As a result, it has been prudent to present three graphs below to offset this effect. The first is based on pre-tax corporate profits, the second on corporate net surplus, and the third is indexed from the profit peak in 2014 set at 100. The last graph is intended to provide a finer view of the path of profits. All data is derived from *Table 1.14. Gross Value Added of Domestic Corporate Business in Current Dollars and Gross Value Added of Nonfinancial Domestic Corporate Business in Current and Chained Dollars, as revised on 28th March 2018.*

The net surplus is taken from Table 1.14 and results from worker compensation being deducted from net value added adjusted for taxes on production, imports and subsidies. (It is useful as well to simply omit the adjustments for taxes and subsidies.) The usefulness of the net surplus is that it functions as a proxy for actual corporate cash flow before EBIT. Thus, it eliminates the follies associated with the December tax adjustments. In spite of the tax treatment, BEA adjustments ensure corporate profits and the net surplus sit on the same plane giving a degree of legitimacy to the corporate figures.

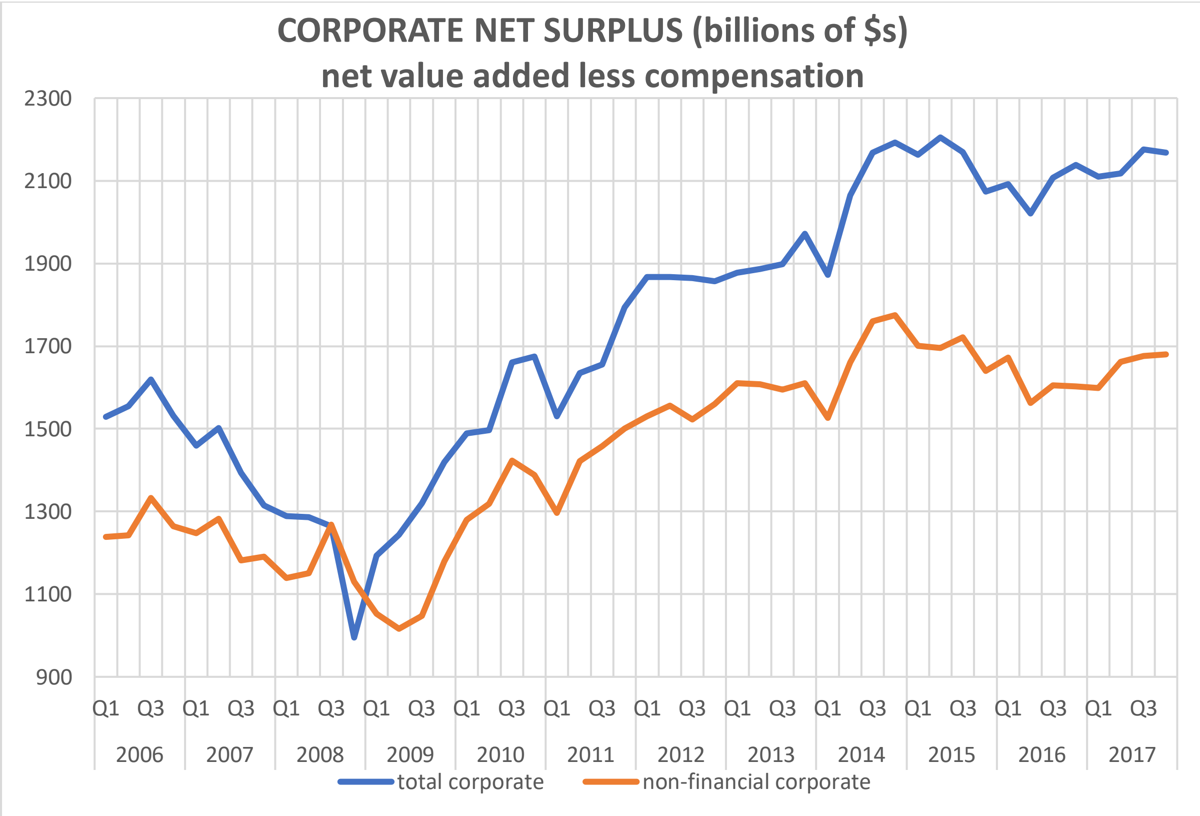
In Graph 2 below we note that the mass of IVA &CCAdj adjusted profits continues to sit below its peak found in late 2014 or early 2015. Non-financial profits are down by 12% adjusted for inflation and for total corporate about half that due to the growth in non-financial profits courtesy of all the bubbles. It should be stated that non-financial profits are themselves contaminated by fictitious profits because the larger corporation run treasury departments which speculate with the cash reserves of these firms not dissimilar to the banks themselves. It must also be noted that the growth rate in the mass of profits has been exceedingly slow since the trough in Q4 2015, or in percentage terms adjusted for inflation, they are only up 6% over 11 quarters (non-financial corporations). Certainly not the growth rate one would expect from the sharper rise in share prices.

The same applies to Graph 3. The real fall in the net surplus is also of the order of 12% (non-financial). However, more recently, the net surplus has been increasing more slowly than corporate profits. Graph 4 shows this most clearly. Relative to the index of 100 in Q4 2014, the profit peak, the growth in the surplus has stalled. This suggests that future profit growth will be under pressure.

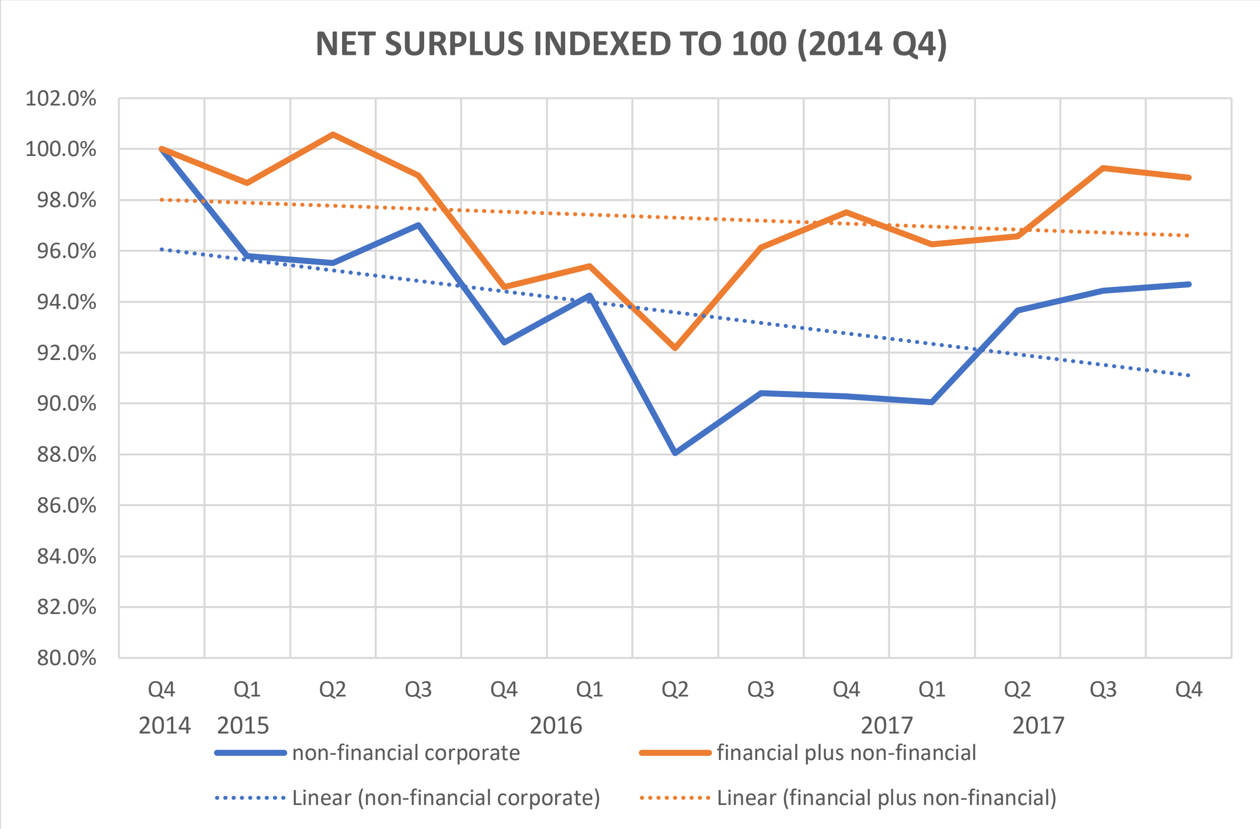
Graph 2.



Graph 3.



Graph 4.



The discrepancy of 23% between the growth in profits estimated by FactSet for the S&P 500 and the BEA is accounted for in the following way. Firstly, the adjustments for Inventory (IVA) and capital consumption (CCAdj) were much lower this quarter compared to Q4 2017. Secondly, the new tax regime has boosted profits by 6% (Source: *The Terrific [But Not Quite as Good as It Looks] First Quarter* by Stephen Gandel - Bloomberg Gadfly, 29th March 2018). Thirdly, according to FactSet, the contribution to profits by the weak dollar accounted for about 6% of the 17% rise in the profits earned by those corporation whose foreign sales are above 50% compared to corporations with the bulk of their sales in the US. Finally, it is likely the large corporations are screwing down the smaller corporations many of whom are too small to register in the S&P 500 and whose profits are proportionately lower. However, even taking these factors into consideration, it is clear there is an element that cannot be accounted for which represents fake profits, which means the monopolies and larger corporations are also screwing their investors.

In my previous report on the US economy on this website examining turnover rates for Q3 2017, https://theplanningmotivedotcom.files.wordpress.com/2018/02/third-quarter-report-pdf.pdf it was noted that turnovers for both manufacturing and goods producing were now falling. As goods producing accounts for well over half the revenue and profits of the S&P 500, these falls in turnover constitute a cap on the growth in the mass of profits because of its depressive effect on the rate of surplus value. I am therefore increasingly of the opinion that the trend in turnovers is a forward-looking indicator predicting the movement in profits, confirmed once again by the actual profits generated in the quarter under review. Further, until there is a significant acceleration in turnover, the momentum to move from rising animation to the phase of prosperity, is absent, because the profits that will spur this transition will not be realised.

It appears that the growth in mass of profits is fading faster than 1937. If corporate profit fell 6% in the fourth quarter when GDP rose 2.9% and the stock markets were roaring, what prospects are there for corporate profits this quarter when GDP is expected to rise by 2% and the markets are bleeding. Despite analysists like FactSet projecting continued profit growth and historically low downgrades to profits, the outlook for profits is cloudy. Beyond this quarter, the outlook for profits deteriorates as the fundamentals in the world economy deteriorate.

There is another consideration; the international context of profits. If it is true that actual profits contracted in the USA at a time when the dollar weakened significantly, then the outlook for international profits has also dimmed. Both the rise in the Yen and the Euro has redistributed profits from Japan and the EU to the USA reducing profits in Japan and the EU and boosting them in the US. This accounts for the weak performance of the DAX, the German bourse. The exception seems to be China despite the appreciation of the Yuan, but then the data from China is always exceptional. Hence if the mass of profits fell in the US, despite the redistribution of profits, it is likely that the unadjusted global mass of profits contracted in the final quarter of 2017.

Prospects for the world economy.

On the 10th March 2017, the ten-year yield touched 2.58% and then tracked lower to reach its nadir of 2.06% on 8th September. Global output topped out in March and only rose again in the second half after the downward trend in interest rates was re-established, or to put it another way, the 30-year bull market in bonds appeared to be intact. These trends were mirrored by the movement of the two bellwether commodities – oil and copper. Both sank to low points by mid-year before retracing their steps in the second half of the year as the prospects for global growth was given the kiss of life by falling interest rates. It was at this point that the legend was born that the world economy had finally changed gear for the first time since 2008.

The result was that in January the markets raced ahead, only to hit the buffers as interest rates rose. This time the new peak reached by the ten-year yield on the 21st February touched 2.94%, causing the markets to gyrate violently. By the end of the first quarter ending 31st March, all major markets including China were down, more than wiping out January's promising start.

Once more the same chain of events appears to be in motion. With the exception of oil, commodity prices are falling once again. The Baltic Dry Freight Index is down. So too interest rates. By the end of March 2017, they had fallen by 0.25% in both the US and China restoring some stability to the markets. The question is whether this fall of about a quarter percent in both countries will continue. Will history repeat itself or will the Trump farce prevent it?

As I have argued previously, it is unlikely that the ten year yield will fall back in the same way it did in 2016. The "corporate/rich people's" December tax give-away combined with the recent spending agreement of $1.3 billion will block such a path. The US must now issue record amounts of debt, an increase of $500 billion, which has always had the effect of pushing up interest rates. As long as the 10-year yield remains above 2.7% and the one year Libor above 2.5% (at current rates of inflation), the US economy remains vulnerable.

The question of whether the world economy will maintain its momentum should be answered over the next couple of months when the effect of the stock market gyrations on the economy are known. Never has an economy been so dependent on bubbles. The transmission belt between the gains on the stock market and the real economy has grown. As the inequality resulting from these bubbles has intensified, so it has come to pass that the top 5% spend as much as the bottom 80% (setting healthcare and residential costs aside). There is now a lethal combination at work. The top 5% whose spending is contingent on the performance of the markets and the bottom 80% weighed down by debt. Should interest rates rise then both sections will become unsettled, the former because it undermines the markets making them feel less rich, and. the latter because increases in their interest payments will make them feel poorer.

Over the month of March optimism about the world economy has faded. It was so brief, but then the world economy is so unhealthy. This is typified by the Conference Board, commonly known by the acronym TED. In January they projected that growth would be so strong that flatlining productivity would give way to more robust improvements for the first time in recent years. They changed their mind in their March report. *What is the growth outlook for the global economy and its core regions in 2018 and beyond, and what major sectors of the economy provide the best opportunities for growth,* asked the Conference Board in its March overview of the world economy? Its answer was sombre: *The global economy is in the midst of a decade long slow growth environment characterized by an imminent productivity growth crisis. The looming labor shortage in mature economies and skill deficiencies in emerging markets will add further challenges to global economic prospect.* ***Global growth lacks demand drivers and potential output is likely shrinking while uncertainty is increasing...*** (my emphasis) https://www.conference-board.org/economic-outlook-2018/ Their answer shows that in turbulent times, a month in economics can be as long as a month in politics.

To this can be added the measure prepared by the OECD titled "investment density" which is also shrinking. Hence on both the demand side and the supply side, there are no drivers.

This conclusion jars with the view presented by groups like McKinsey who predict that we are on the verge of a digital revolution. It is true that the digital mechanisation of production is accelerating not decelerating which is why China is being forced to mechanise with the loss of tens of millions of industrial jobs. But here is the rub. It is stripping value out of the production chain as automation displaces labour. Hence it is not contradictory to hold both views, both on productivity and technical change, because the formula for productivity has as its numerator, the value of output.

Therefore, the concerns about inflation which haunts the FED, are misplaced. Doubly so since China is about to mechanise whole sections of its manufacturing base. Marxists should note that in such an environment, not only are the mass of profits under pressure, but industry is less able to endure higher interest rates in an environment where revenue is declining because of the destruction of value by mechanisation. While the OECD has recently revised the number of jobs at risk from automation, from 47% (estimated by Oxford Academics Carl Frey and Michael Osborne in 2013) down to 14%, (https://read.oecd-ilibrary.org/employment/automation-skills-use-and-training_2e2f4eea-en#page7 the figures are still plastic as not enough is known about the scale of the developments and the limits to machine learning. (Note 1.)

The final consideration is this. When value in production is destroyed, capitalism seeks to compensate for this destruction by increasing the volume of production. The projected digitalisation of production will result in a destruction of value on a scale hitherto not seen, but consistent with the development of the technique of production. It is in this context that the next phase of globalisation must be seen. The substitution of volume for value requires the concentration, even centralisation of capital on an international scale and the cultivation of international markets. Here the platforms like Amazon and Alibaba fulfil this potential as they are able to link producers in every part of the world with consumers in every part of the world.

However, just as capital needs to be concentrated internationally, the inequality which the first round of globalisation caused, has given rise to national populism which acts as a barrier to this, and which will blossom further with the next recession. Simultaneously, on the other side, the metabolism of capitalism is constipated with excess debt and zombie companies, both which require being purged from the system. If interest rates continue to rise, the day of reckoning can no longer be avoided. Already there are indications of defaults spiking at smaller banks for credit card and car loans. Under these circumstances there will be a simultaneous destruction of unproductive capital and a centralisation of productive capital.

As a concluding remark, it could be argued that the turbulence experienced is predictable for a world economy transiting from easy to normal monetary conditions. This view is undermined by the comparable effect in both March 2017 and March 2018 when interest rates reached new peaks. On both occasions the acceleration in the world economy was arrested. Three scenarios present themselves. Production will retreat back to the insipid growth since 2008. Two, the world economy will punch through the turbulence though this is unlikely given the evidence to date. Or, finally the long-delayed purging of excess capital and debt will occur because of the scissors effect of rising interest rates and falling profits. The next few months will tell.

(Note1.) Having begun to research, deep mining, machine learning and Artificial Intelligence for future articles, it is clear that the experts cannot agree on these terms. This author though is convinced that there is no such thing as Artificial Intelligence nor will there be for a considerable period of time. The first computers were analogue, consisting of energy wasting and time consuming cogs and cranks. Today's more rapid computers are digital and inorganic. Our brains however are not digital, but organic and biological **analogue** computers. We store knowledge as analogue imprints, trillions of them, organised and connected logically, not as zeros and ones, despite the switching process between the soma and dendrites of adjacent neurons being activated by "action potentials" which are on-off mechanisms not dissimilar to digital switching. It is this latter aspect that has encouraged computer designers to mimic the function of neurons which helps with computation but not intelligence. Digital computers can locate patterns, or what is the same thing, make connections, but they cannot imagine a new pattern with no prior existence. Hence what is termed Artificial Intelligence is really machine learning.

Brian Green, March 2018.