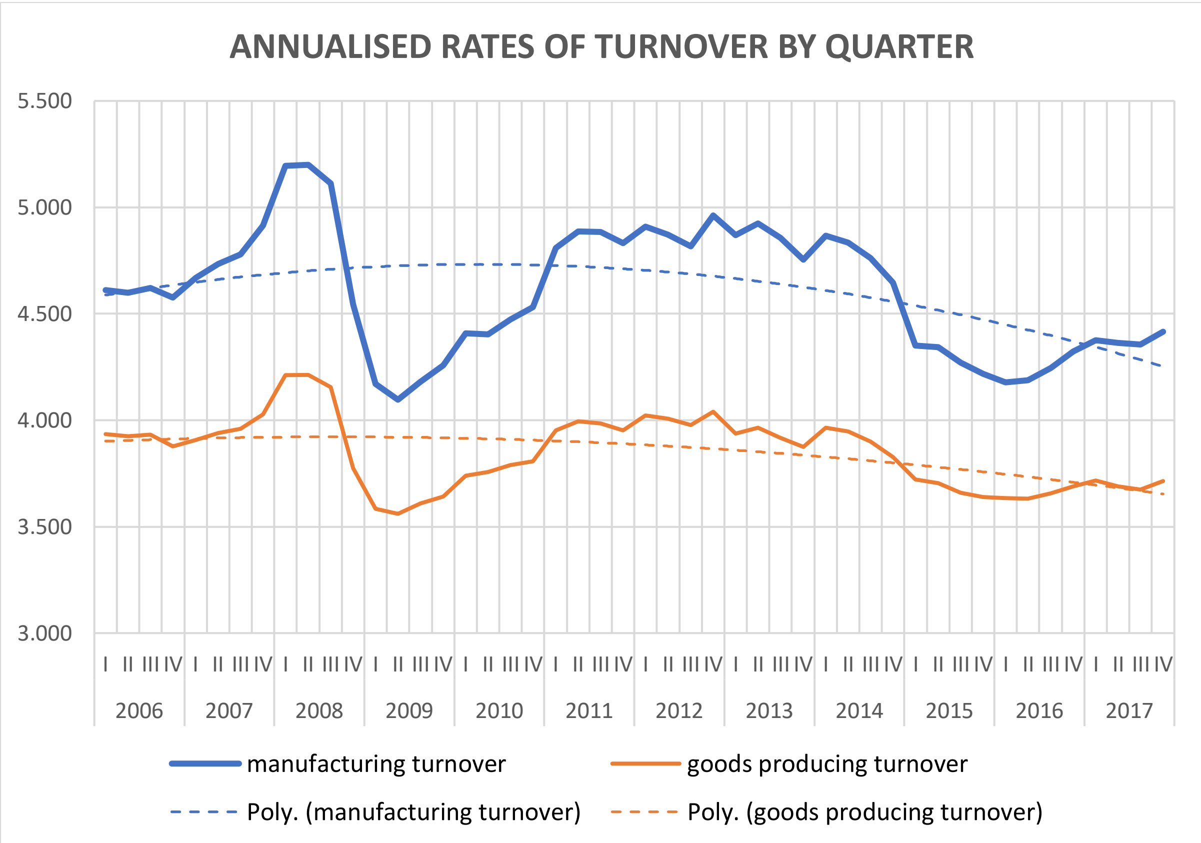
REPORT ON THE US ECONOMY FOURTH QUARTER. THE EFFECT OF RISING WAGES AND FALLING PRODUCTIVITY OBSCURED BY TRUMP TAX CUTS.

This is a regular quarterly report. What is unique to this report is the abrupt change in the rate of exploitation and therefore the movement in profits. All of this has been obscured by the Trump tax cuts whose anticipation and implementation gave a temporary lift to the economy. If the rate of exploitation continues to fall, weighing on margins and dragging down profits for another quarter, then the industrial cycle has fully matured, but uniquely without scaling the heights of the previous cycle.

The only positive feature has been the acceleration in the rate of turnover. This is consistent with the period of anticipated tax cuts and the rebuilding/restocking after the hurricane season. The quarterly uptick was sufficient to raise the rate above its recent high in the first quarter of 2017 forming a new post-2014 peaklet. Nonetheless the rate remains well below its 2014 levels and for as long as it does, it will act as a brake on the overall production of profits.

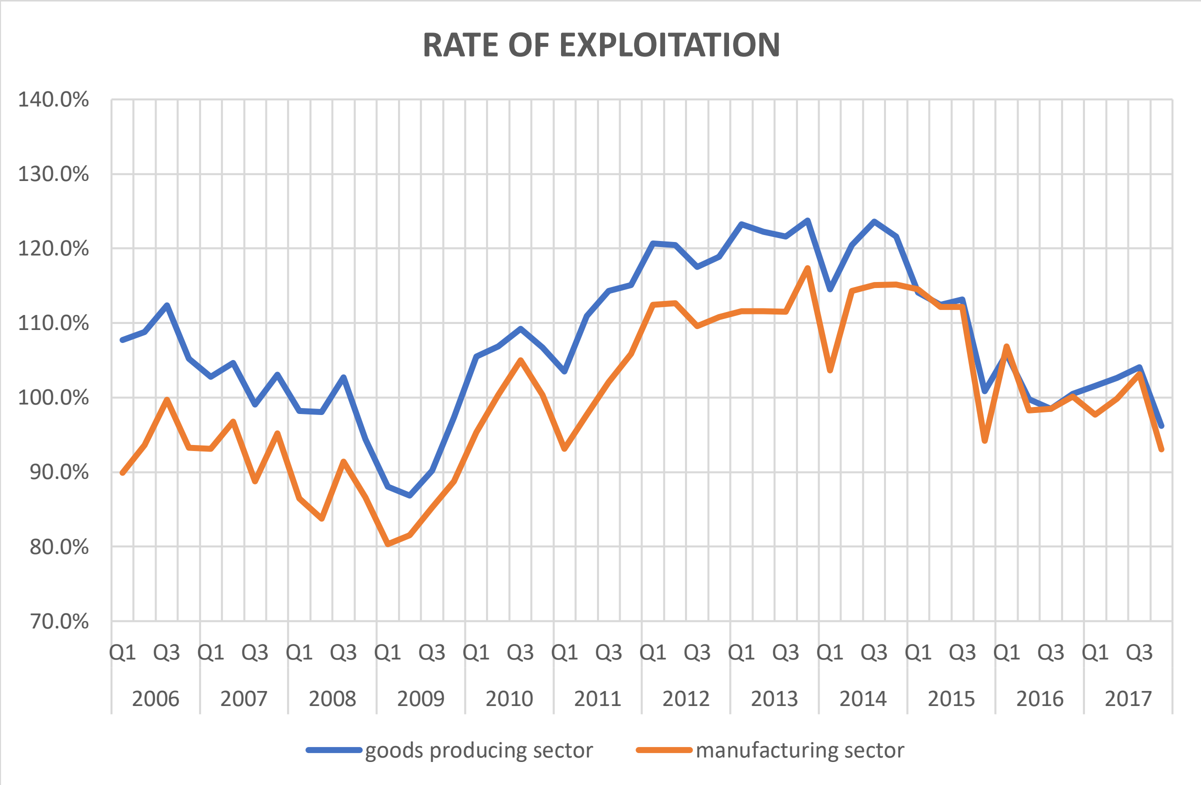
Graph 1.



(BEA Interactive Tables, GDP-by-industry Gross Output and Gross Value Added Tables for turnover.
Rate of turnover = G0/GV+(GO-GV)/GV where GO = gross output and GV = gross value added.)

It is likely the rate of turnover will tick-up again in Q1 2018. The improvement in the rate of turnover however was insufficient to offset the very sharp fall in the rate of exploitation. In both the goods producing and the manufacturing sector the fall was large enough to reduce the rate to levels last seen in 2010 when the economy was moving out of recession.

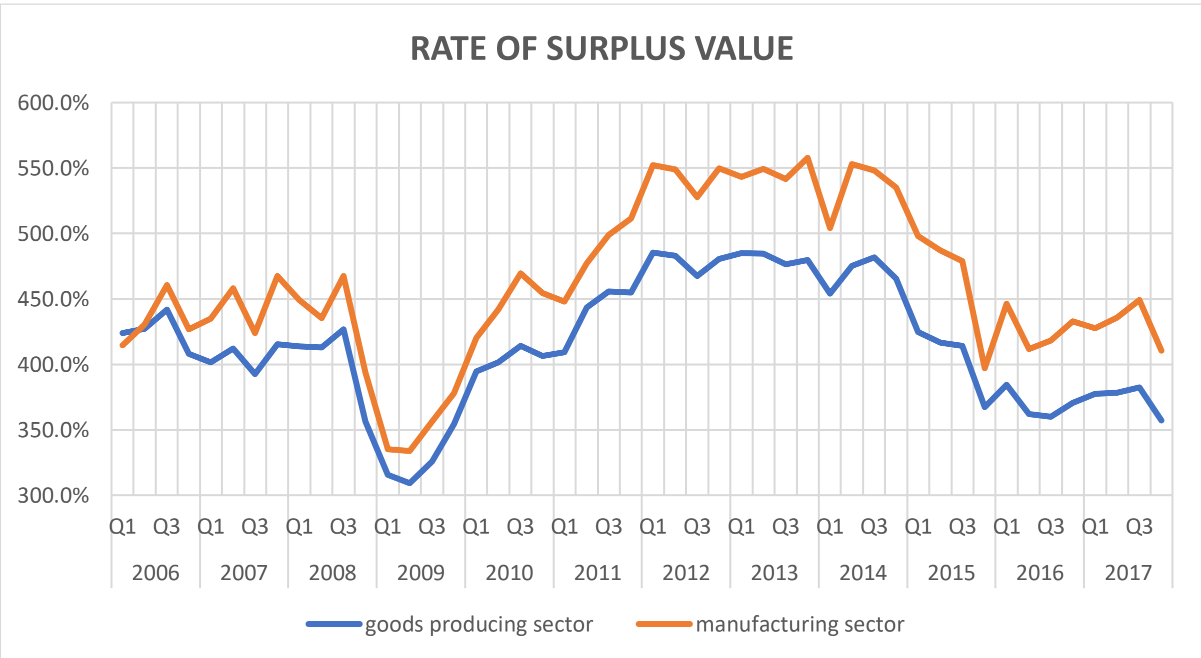
Graph 2.



Source: BEA Interactive Tables, National Income Tables 2.2B for wages, Table 6.1D for net value added.)

In my previous report I queried the rise in exploitation for the third quarter, which then subsequently reversed into a sharp fall. This fall in the rate of exploitation has overpowered the rise in turnover, ensuring that the all-important rate of surplus value would decelerate.

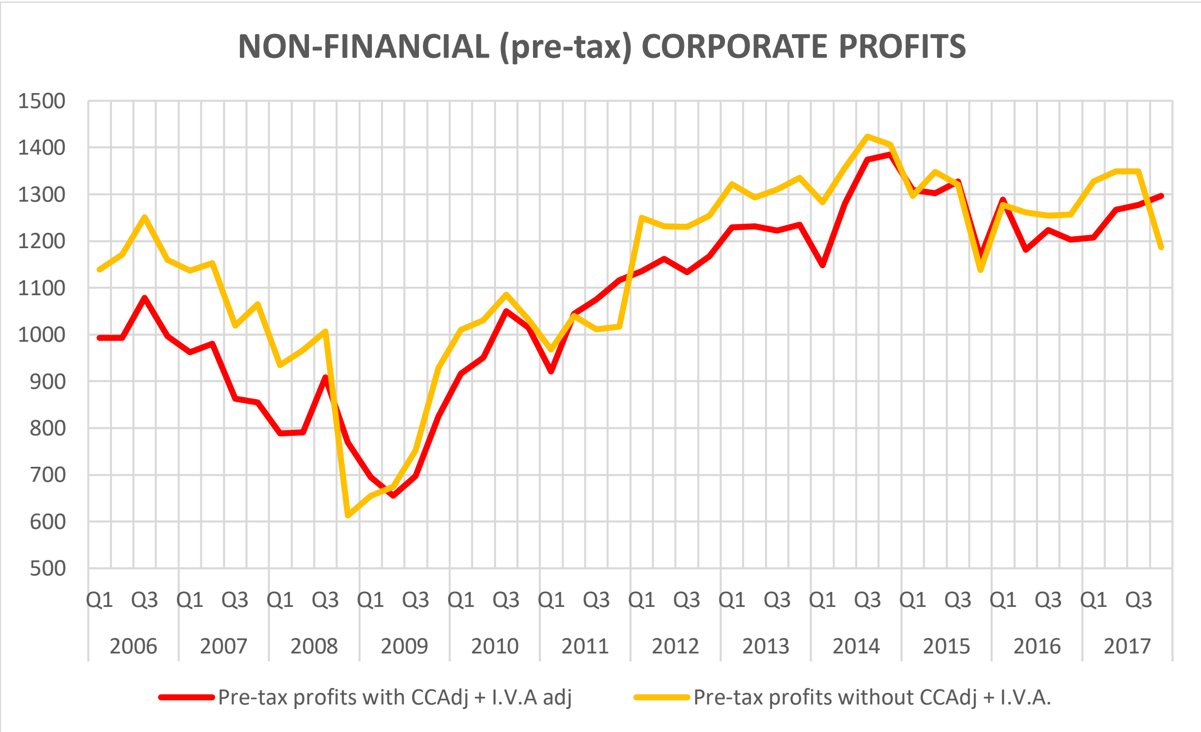
Graph 3.



(Source: As for rate of exploitation and turnover graphs. Rate of surplus value = rate of exploitation x turnover)

The rate of surplus value is now reducing to levels last seen in 2015 when the pseudo recession occurred covering the last quarter of 2015 and the first quarter of 2016. Over these six months the world economy stalled, but because low interest rates propped it up, it did not enter a full-blown recession. Clearly a fall in the rate of surplus value impacts the mass of profits as Graph 4 below shows. Something has to give. Either productivity has to rise, or wages have to be depressed further, if the rate of exploitation is to be reversed. The standstill in real wages since March 2017 is clearly insufficient to support a sustained rise in the rate of exploitation. (A different look at profits is introduced in this article which includes both adjusted and unadjusted data as opposed to adjusted data in previous articles. Note 1, at the end, explains the methodology behind the two series.) Unadjusted profits fell in line with the fall in the rate of surplus value while adjusted profits did not. This was due to the scale of adjustments. Unadjusted figures are important because it is the one tracked by the highly influential "Bloomberg Econoday" report. This report came as a shock to unprepared investors because the previous FactSet report on S&P 500 earnings per share had shown a sharp increase in profits. Obviously, the unadjusted profit is more closely associated with the rate of surplus value, but the key observation is that a fall in the unadjusted mass of profits precedes a fall in the adjusted mass. The link is prices. In a downturn with its pressures on prices, adjustments are reduced and the gap between the two masses is minimised.

Graph 4.



(Source: National Income and Output Table 1.14 release date 27th April 2018. Line 20 for adjusted non-financial profits, and line 47 for unadjusted non-financial profits.)

It is worth noticing that the fall in the unadjusted mass of profits is equal to the fall that occurred in the final quarter of 2015. The outlook for profits this quarter is muted. Productivity has improved but not sufficiently to prevent labour costs rising. The employment cost index for the quarter ended March rose to 0.8% from 0.6% the December quarter (BLS report dated 27th April 2018). In a separate report non-farm business labour costs rose from an annual figure of 2.1% to 2.7% (BLS Table 2 report dated 3rd May 2018). Productivity rose for non-farm business but not for manufacturing which was stuck at 0.5% resulting in the pace of labour costs rising from an average of 1.9% to 2.7% (BLS Table 3 report dated 3 May 2018). Altogether, the rise in employment/labour costs mitigates against any significant change in pre-tax corporate profits. Non-financial profits will be higher because of the return of volatility to the speculative markets during the quarter ended March.

All will be made clear by the end of the month when the BEA will issue its report on first quarter non-financial profits. This time around, the gap between S&P 500 headline profits per share and the underlying mass of profits will be even greater. FactSet currently reports an annual 24.5% increase in EPS, the highest ever recorded (based on 81% of corporations having reported) for the S&P 500.

However, much of this improvement was due to the silly Trump tax cuts. As we shall see in Apple's case later, 60% of its increase in profits was due to lower tax. Without these tax changes the increase would only have been 10%. Apples tax windfall is on the high side. The average estimate for the benefit of lower taxes on this 24.5% in profits ranges from one third (Credit Suisse and Bloomberg) to over 50% (Goldman Sachs). If we assume the figure of around 50% then FactSet's figure reduces to 12.5% for pre-tax profits.

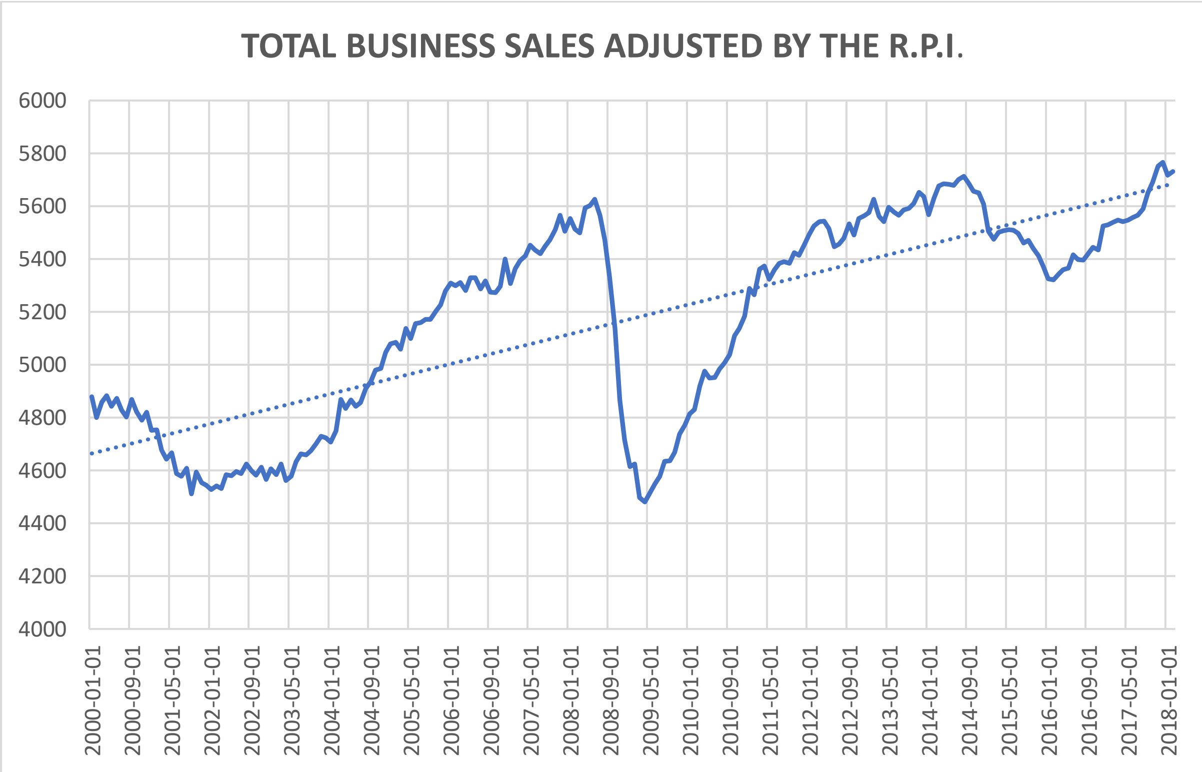
Of this 12.5%, Bank of America estimates 2.5% is due to favourable foreign exchange rates and Yardeni estimates that another 2.6% was due to share buy backs. This reduces the growth in profits to around 7.5% before adjusting for inflation. Further, these profits gains were driven mainly by the tech monopolies, oil/gas companies and banks that benefitted from the volatility during the quarter. The smaller companies, those that lie outside the S&P 500 will see their profits depressed by monopoly gains and increases in oil prices. Hence taken together with the rise in labour costs, the balance appears to be no increase to a small decrease in overall profits.

Total business sales.

I have always proposed that until the mass of profits, in real terms, exceeds the previous peak, the current cycle cannot be described as having entered into its "prosperity phase" as defined by Marx. A secondary indicator for phasing the cycle is *Total Business Sales* which comprises over half the sales in the economy and encompasses manufacturing, wholesaling and retailing. It has now reached, in real terms, the peak last seen at the end of 2014.

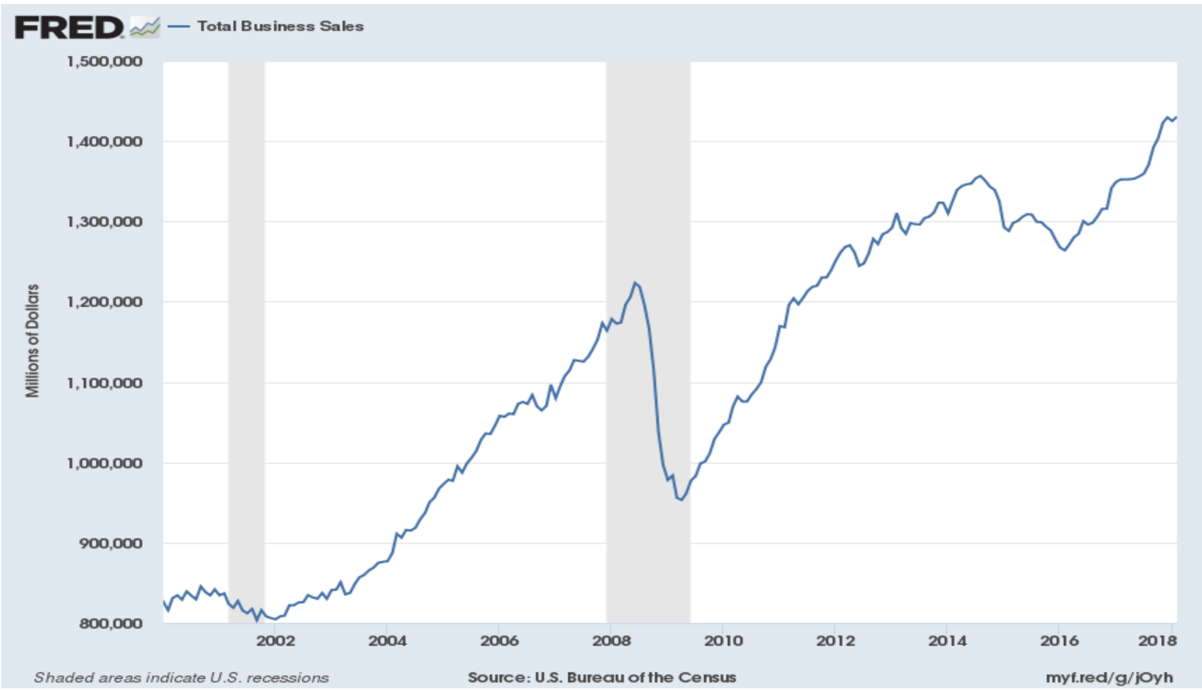
Much of this stimulus originated from the damage inflicted to the Southern States by a violent hurricane season which required replacement and repair of destroyed and damaged property. Nearly one million cars were written off for example. However, what the last quarter has shown is that this effect has worn off before the stimulus from tax cuts has kicked in. In fact, the reason for the insipid growth in GDP covering the first quarter of this year was the deceleration in personal consumption expenditures which grew at their slowest pace since early 2016. Graph 5 describes real growth.

Graph 5.



Graph 6 describes nominal growth unadjusted for price rises. The data for both graphs are derived from the series produced by FRED on business sales. (Federal Reserve Bank of St. Louis = FRED)

Graph 6.



The issue of interest rates.

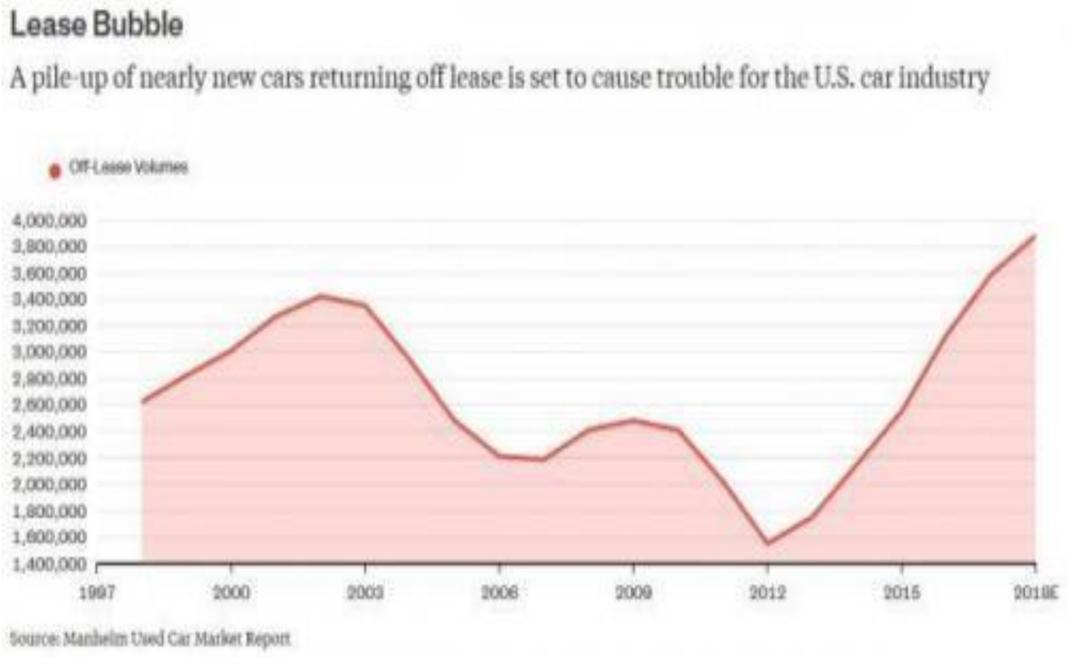
The issue of interest rates is now becoming acute. I proposed a rule of thumb for the 10-year rate of interest as core inflation plus 50% or 1 whichever was larger. Six months ago, core inflation was 1.8%, which by adding a half or 0.9% or 1%, formed the critical 2.7- 2.8% yield for the 10-year bond. This was the level at which I proposed, interest rates would begin to affect both investment and demand. The equivalent rate today is 3.0% given a core inflation rate of 2.1%.

All other interest rates have mirrored this effect. The prime overdraft rate has increased by 50% from around 3.2% last year to 4.75% currently. The LIBOR rates have also shot up, the 3-month rate has risen from 1.18% a year ago to 2.35%, the 6-month from 1.45% to 2.52 and the 1 year from 2.75% to 3.5%. Not only is this rate used to set all derivative borrowing rates (including leverage) but it is also the rate at which commercial banks lend to each other. Any abrupt rise reflects growing credit tensions. The last time rates were at this level was in the immediate period before the financial crash in 2008 when inflation was actually higher.

Sub-prime auto loans are of particular and growing concern. Their quality has fallen further dragged down by the collapse in second-hand car prices due to the flood of second hand cars entering this market (Graph 7). The effect of the fall in second hand prices is to increase the size of new loans which have become more expensive due to rising interest rates. This has made sub-prime loans less affordable and put in jeopardy existing sub-prime auto loans. 90+ day delinquencies in this $300 billion sub-prime market have risen to 9.7%, a figure only surpassed at the height of the 2008 financial crisis.

While the size of the sub-prime auto market at $300 billion is only a quarter that found at the time for sub-prime mortgages, it is still a significant sum, whose losses are concentrated outside the main banking system. In addition, these loans have not been spliced and diced, then leveraged to the same degree mortgages were prior to 2008. That being said, should half a million cars, below, be depreciated by 5,000 dollars that loss alone represents a multi-billion-dollar loss.

Graph 7.



According to the latest report on household delinquencies the stable conditions found 2016 and the first half of 2017 have been replaced by increased delinquencies in the third quarter, (the most recent figure). More data can be obtained by downloading the whole report which can be found on https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2017Q3.pdf What is of primary importance is that the rate of delinquencies never fell to the lows found prior to the crash in 2008. The current level is equal to the level which obtained in mid-2007 or twelve months before the crash. It is also important to note that interest rates picked up only in Q4. Delinquencies, besides auto loans, were also concentrated in student loans, that most onerous of loan.

However, the real threat of insolvency is to be found, not in the household sector, but in the $10 trillion corporate bond and lending market. The pseudo recession at the end of 2015 did not flush out zombie debt, since which time corporations have continued to binge on debt fuelled by low interest rates. In 2017 alone $1.7 trillion dollars of new debt was issued. Most of this debt was not issued for investment in means of production and therefore the expansion of profits, but for other purposes. The biggest segment of issuance has been covenant-lite BBB rated debt. This low-quality debt was lapped up by investors desperate any kind of interest income. Much of this debt has been issued by corporations whose earnings barely cover their interest rate obligations and who could easily go underwater if the economy stalls.

They are therefore ticking time bombs. According to the FED governors they are not about to go off yet. According to current FED data, write offs remain stable. The last quarter of 2017 saw write offs that were on par with the average for 2017. But the level of write offs for the whole of 2017 was consistent with the levels for 2007, when the environment was also described as benign. It is always the case that financial conditions remain stable until they don't.

Finally stresses in Emerging Markets have been emerging. This has been detailed in Michael Roberts recent blog https://wordpress.com/read/feeds/313842/posts/1851081825 The stability of this debt continues to depend on the profit outlook.

CREATering Britain.

Britain is in recession. The first 0.5% of GDP is merely statistical noise. Car sales are plummeting, construction is up against the wall and Brexit is looming. This article will not dwell on the travails of this economy except to say two things. Firstly, Britain has now become the weak link in the major capitalist economies. Secondly, it is an example of what happens when a government is determined to run a budgetary surplus regardless of the state of the economy. The second point has yet to be picked up by the Labour Party.

This drive for a budgetary surplus has not only impacted on the lives of British workers through cuts to services, particularly local government services, but it has impacted on all the companies that grew fat on services. All of them, especially Interserve, are now floundering in debt. This extends to the highly leveraged care home sector as well.

Britain and Germany are the only two economies in the world to run a budgetary surplus on day to day expenditure. But whereas Germany dominates Europe and is supported by a large export surplus, Britain is being hollowed out by Brexit and a large deficit on its balance of payments. Britain is thus in a precarious state, and our illustrious Bank of England governor, whose housing and relocation costs alone could have ended rough sleeping in London, is out of his depth. Britain will not grow by 1.4% but will continue to contract. The view that this state of affairs is temporary is about as surreal as the Brexiteers vision that freed from Europe this island can sail into the inviting arms of all those dynamic economies.

Part of this view about the health of the economy is fed by headlines of full employment. If only. Both Britain and the US do have a special relation, they both fool themselves about full employment. The Bank of England is aware, that whereas twenty years ago over 80% of the unemployed sign on, today that figure is barely 50% because of the draconian benefit system. This being so, over half a million workers who would have appeared on the unemployment rolls, have simply disappeared. Many of those that do work, as in the USA, work only a few hours a week on precarious contracts. But here the difference with the USA ends. At least in the UK there is a semblance of education. In the US, there are tens of millions of unemployed workers, but the majority are uneducated because the Republican Party obsessed with giving tax hand-outs to the rich and their mates, has robbed the education system. Surely a case of the goose killing the golden egg and testimony to the decline of US imperialism.

Finally, concerns about the growth of the world economy continue to growth. Various surprise economic indicators have started to flash red unnerving investors. South Korea, often considered the canary in the coal mine because of its export prowess, has seen its exports fall for the first time in two years.

Once more on Apple Inc.

"Customers chose iPhone X more than any other iPhone each week in the March quarter, just as they did following its launch in the December quarter. We also grew revenue in all of our geographic segments, with over 20% growth in Greater China and Japan." declared Tim Cook announcing Apple's surprising Q2 2018 results which covers the period January to March of this year. I have previously declared that Apple has lost its way. However, the strength of the Q2 report suggests otherwise, or does it?

Prior to Apple's results many analysts, examining Apple's supply chain, opined that Apple's results would be lacklustre and that the iPhone X in particular had suffered such a sharp fall in sales that its future was in jeopardy. "*Smartphone shipments in China suffered their biggest ever decline in Q1 2018, down by more than 21% annually to 91 million units, a number first passed some four years ago in Q4 2013. Eight of the top 10 smartphone vendors were hit by annual declines, with Gionee, Meizu and Samsung shrinking to less than half of their respective Q1 2017 numbers. Huawei (including Honor) managed to grow shipments by a modest 2%, maintaining its lead and consolidating its market share to about 24% by shipping over 21 million smartphones. Second-placed Oppo and third-placed Vivo bore the brunt of the overall decline, with shipments falling by about 10% to 18 million and 15 million respectively. Xiaomi was the only company to buck the trend, growing shipments by 37% to 12 million units, and overtaking Apple to take fourth place."* (CNN report 27th April and four days before Apple's own report quoting Canalys data.) And again: *"Fast Company says it knows some people with inside knowledge of the Apple supply chain and they told it Apple is cutting its orders of the iPhone X from its manufacturers because it's struggling to move the stock it already has. Apparently, Apple has only ordered 8 million units for Q2 2018, which is way less than you would expect from a company that would expect to ship over 40 million units of all its phones in that quarter*. (Source: Telecoms.com)

It was this 21% fall in sales that contributed to the global fall in smartphone sales of 2.9% to 334.3 million units as reported by International Data Corporation. IDC further reported that the only significant trend was that subscribers were trading up to more expensive models though this is overstated. According to Statista global smartphone revenue was up 8.8% in 2017 against a volume fall it puts at 0.5% or below the IDC figure. (There is a degree of variation between analysts given the size of the markets and revisions after phone companies report their earnings and sales.)

Hence the average price achieved was up 9.3% which admittedly is faster than previous year. Indeed, as the table shows this accelerated to 10% in the fourth quarter of 2017. But this does not take into account the depreciation of the Dollar. If we compare Q4 2017, the month the X phone was launched, to q4 2016, the dollar fell by 4.7% which means we are not comparing like with like. An interesting way of circumventing the conundrum created by a falling dollar is to contrast the annual rise in the value of sales in the US versus the rest of the world. In the US, the value of 4^{th} quarter smartphone sales rose by only 4% as the table below shows. (However, the rise in volumes does not tally with other data.) Nevertheless, there is a sharp divergence in the value of sales in the USA versus the rest.

Smartphone sales 4Q 2016 vs. 4Q 2017	Units sold (in million)			Sales value (in billion USD)		
	4Q16	4Q17	Y/Y % change	4Q16	4Q17	Y/Y % change
Western Europe	38.3	37.0	-3%	16.1	18.8	17%
C & E Europe	23.6	25.2	7%	5.4	6.9	28%
North America	58.7	62.0	6%	27.4	28.5	4%
Latin America	33.1	35.0	6%	10.0	11.2	12%
Middle East & Africa	42.6	46.2	8%	10.6	10.9	3%
China	118.4	114.7	-3%	36.6	43.0	17%
Developed Asia	20.3	18.5	-9%	13.9	13.2	-5%
Emerging Asia	58.9	58.6	-1%	10.1	11.5	14%
Global	**393.9**	**397.2**	**1%**	**130.1**	**144.0**	**11%**

Source: GfK Point of Sales (POS) Measurement data in 75+ markets, monthly data to the end of November 2017, plus weekly data to 31 December 2017. Percentages are rounded.

This is the global background against which Tim Cook announced Apples results for the First Quarter of 2018, which contained revelations such as a 3% increase in unit sales globally and a whopping 21% increase in China from 10.7 million units to 13 million. And this at a time when *Huawei* and *Xiaomi* both increased their sales, with the latter increasing its sales by 37%. It therefore seems unusual that in a market which fell by 21%, and where on balance Chinese vendors increased their sales, that Apple would record a sales increase of 21% in volume, unless the CCP instructed all its senior cadre to buy the X phone to try and reduce its trade balance with the USA.

If we take Tim Cook at his word, we could expect that the average selling price increased in Q2 due to the higher density of sales of X phones. In the previous quarter the X phone was only available for two months amidst problems of supply. Therefore, the density of sales would have been less. This would have been reflected in the average sales price of iPhones. And yet when we examine Apple's quarterly summary, the facts do not support the hype.

Average Sales price of iPhones (price in $s)

year	2016.1	2016.2	2017.1	2017.2	2018.1	2018.2
price	690	642	695	655	796	728
Change by qtr.		-7.0%		-5.8%		-8.5%
Change by year			+0.7%		14.5%	11.0%

(Source: Apple investor relations, Q2 2018 and Q2 2017 Unaudited Summary Data.)

There was an unusually large fall in average prices quarter on quarter in 2018.2. (Apple's quarters are confusing. Q2 refers to the period January – March and Q1 refers to the period October – December.) In the last quarter, Q2, the average sale price fell by 8.5% compared to the last quarter of 2017 or 2018 Q1. The comparable figure the previous year was a 5.8% fall. Further, if we take the annual change in price then the price hike in the last quarter of 2017 was +14.5% falling to 11.0% in the first quarter of this year. These figures are not consistent with Cook's claim that the X phone was outselling the other iPhones every week unless of course these phones were being heavily discounted.

The clue that this could be the case lies in the operating margin. All data is taken from Apple Inc. *Q2 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)* available on their investor website. Contrasting q2 2018 (the most recent quarter ended March) to q2 2017 the following changes are observed:

Change in sales revenue	15.6%
Change in cost of sales	16.7%
Change in gross margin	13.7%
Change in margin after SGA + R&D expenses	12.7%
Change in pre-tax profit	10%
Change in cash flow	9% (for the six months)
Change in post-tax profits	25%
Change in share price (mid-Feb to mid-Feb)	27% (Source: Nasdaq)

This rise in sales revenue is price driven not volume driven. Volume sales of iPhones, iPads and Mac computers (representing 80% of total revenue) rose by less than a quarter percent. All the revenue increase was driven by the rise in the average selling price of these products. However, the cost of producing this revenue increased faster that did the actual revenue reducing the gross margin increase by 1.9% relative to revenue, and, by a further 1% after selling/admin expenses and R&D are added in, and, finally due to a fall in "other income", to only a rise of 10% in pre-tax profits. This is comparable to the 9% increase in cash flow which is always the most important data point. Given that 60% of Apple's revenue is sold abroad, most of it in local currency, the benefit to revenue, is 3% from the depreciation in the dollar. This is not the stellar performance the headlines suggest.

Given that iPhones represent 60% of total revenue, the mix of phones has not improved Apple's margins which continue to fall. The increase in cash flow is only 57% that of revenues and it has been flattered in turn by the depreciation of the dollar. When measured against actual cash flow, share prices which increased by 27%, have increased three times faster than actual cash flow or the change in pre-tax profit. What has flattered Apple's share price is the Trump gift of tax cuts which has turned a 10% rise in actual profits into a 25% rise in post-tax profits.

Little wonder Apple is scrambling around to bring production in-house to reduce its cost of sales. It has pulled off one trick, introducing more expensive phones, which is a one-time gamble, the longer-term trick depends on cutting costs. It will be interesting to see if Apple can bring chip and screen production in-house. Investors are betting they can.

Detractors including myself got it wrong, or so it appears, about the sales of the X phone. Will we get it wrong in Apple's next report? Unlikely. Apple is taking a huge gamble by turning its phones into luxury goods, focusing on the top 5% for their market, when that segment of society depends on the direction of the stock market and house prices. Substituting price for volume is not a sign of strength but of weakness. The sharp fall in average prices already if proof of that.

I have concentrated on the FAANG corporations. These monopolies exemplify the fragility of the economy which they dominate. While Apple actually generates sales for its revenue, Facebook and Google continue to depend on their monopoly of digital advertising revenue. Even Amazon has yet to prove it can make a real profit, instead of capitalising costs like leasing (while driving their workers demented by over working them). Even its model, of paying workers to collect and deliver products that consumers in shops do for free by walking up to a shelf, removing the item from the shelf, taking it to the check out then driving it or walking it home, is not certain yet. A point will come when Amazon cannot hide behind its strategy of buying market share and enjoying a price to earnings ratio of over 200. Either its profits need to go up ten-fold or its share price needs to fall by 180%. The most important metric to observe is that while Amazon enjoys the same gross margin as most retailers, 37%, its operating margin of 2.4% is unsustainable (remembering that this margin would be an actual loss where it not for its treatment of leasing costs).

In conclusion.

This article does not draw firm conclusions. More will be said when the BEA reports Corporate Profits on the 22nd May. In addition, by then, it will be clearer whether the temporary lull in stock markets is merely a pause in volatility or the resumption of stability. Certainly, Mr Trump has rolled back the kind of rhetoric that has buffeted the markets, for here is a president whose wealth gives him an interest in stroking the neck of the markets. Of course, all this will be overwhelmed by the cascading budget deficit his tax cuts have unleashed and the effect this will have on interest rates.

Note 1.

Capital consumption allowance (CCA), (private). Consists of tax-return-based depreciation charges for corporations and nonfarm proprietorships and of historical-cost depreciation (calculated by BEA) for farm proprietorships, rental income of persons, and non-profit institutions. *Related terms:* consumption of fixed capital (CFC), capital consumption adjustment (CCAdj).

Inventory valuation adjustment (IVA). An adjustment made in the national income and product accounts (NIPAs) to corporate profits and to proprietors' income in order to remove inventory "profits," which are more like a capital-gain than profits from current production.

Brian Green. 13 May 2018