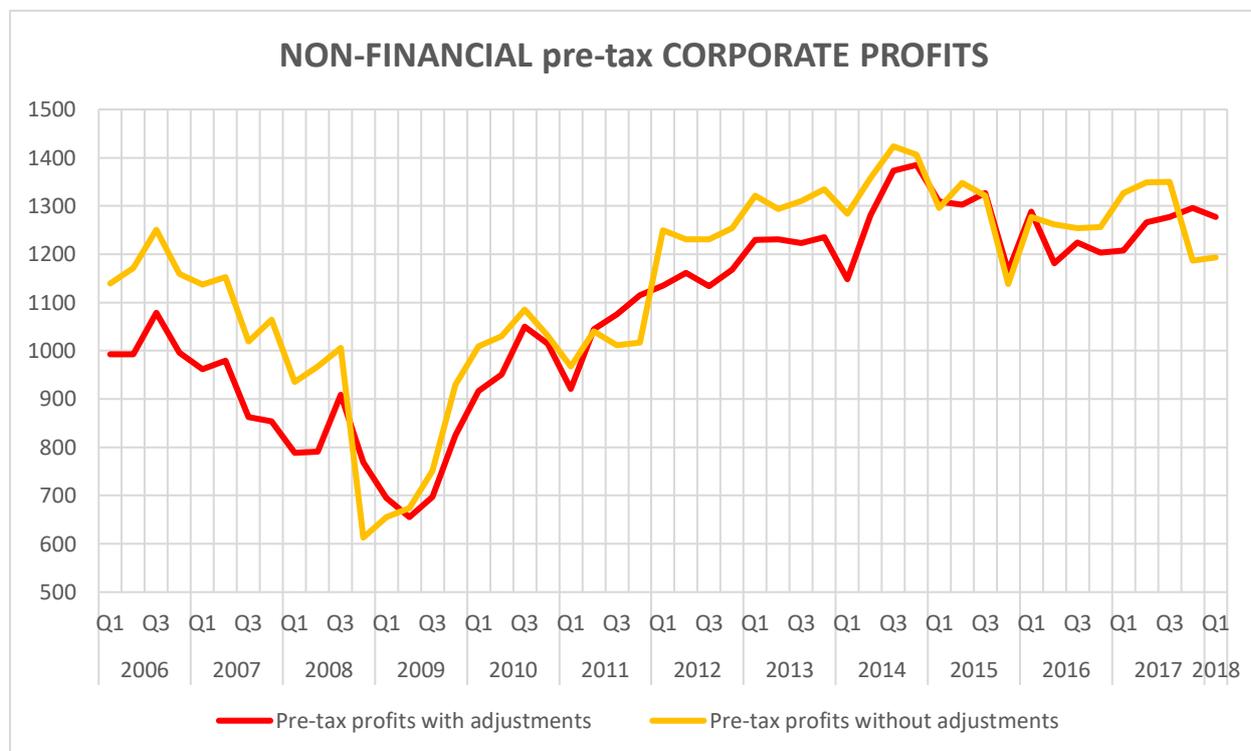


THE EFFECT OF 6 MONTHS OF FALLING PROFITS, STILL OBSCURED BY THE ADRENALIN RUSH PROVIDED BY TAX CUTS.

The BEA just released the advance figures for corporate profits covering the first quarter of 2018. Despite a weak dollar which added \$10.3 billion in profits, on balance, non-financial corporate profits were down. This can be seen from the graph below which plots both adjusted and non-adjusted pre-tax corporate profits.

Graph 1.



(Source: 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*, line 34 for adjusted profits and line 47 for unadjusted profits.)

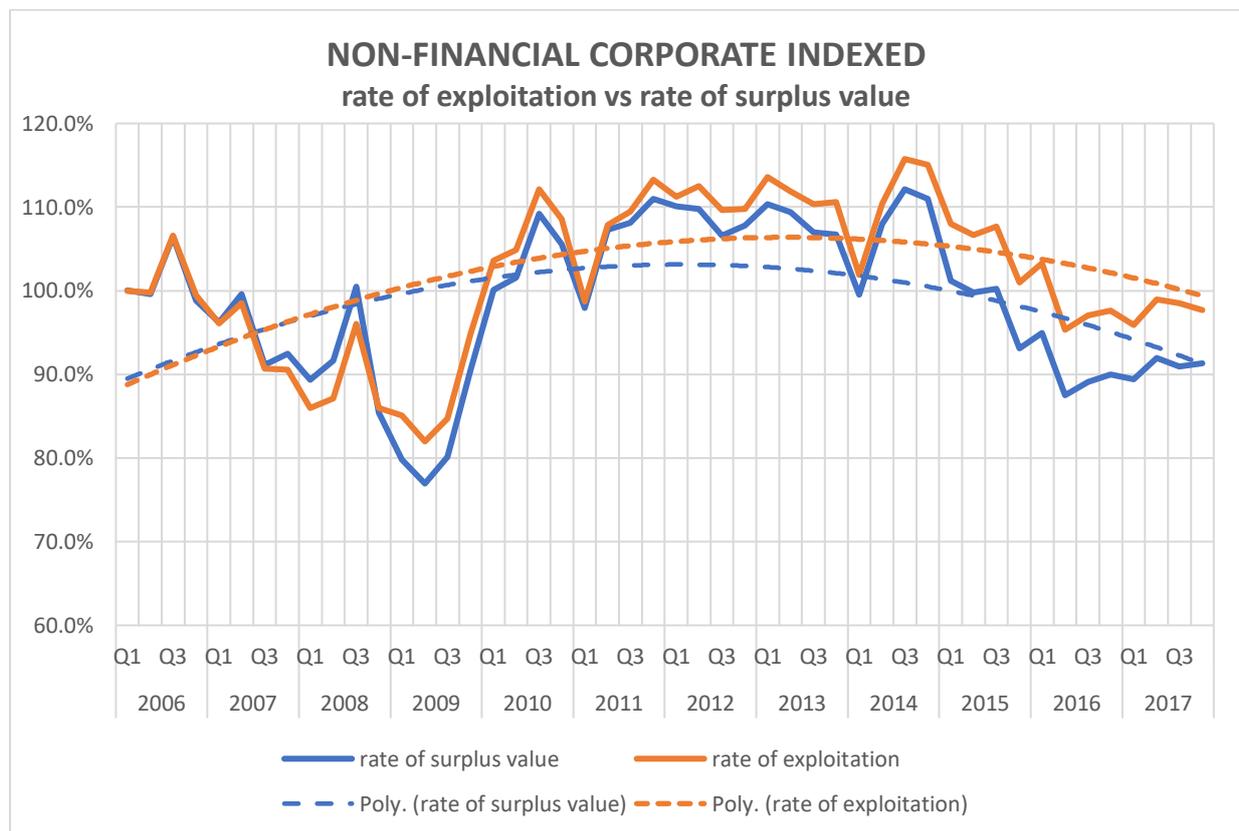
As stated in the previous analysis of profits, there is a definite relationship between adjusted and unadjusted profits. (<https://theplanningmotivedotcom.files.wordpress.com/2018/05/4th-quarter-us-economic-report.pdf>) Unadjusted profits (free of CCAAdj and I.V.Adj.) are closer to the rate of surplus value than are adjusted profits. Furthermore, changes in unadjusted profits usually precede changes in adjusted profits. In Graph 1, there was a sharp fall in unadjusted profits during the final quarter of 2017, while adjusted profits continued to rise. It was therefore to be anticipated that there would be a subsequent fall in the adjusted figure, which has occurred. In annual terms, the adjusted figure is up by 5% and the unadjusted figure is down by 10%, meaning on average that pre-tax profits have fallen.

Once again, this fall in underlying profit has to be set against FactSet's 24.6% increase in Earnings per Share (EPS) for the S&P 500 (release date 25th May). This rise is due to the tax cuts (EPS is a post-tax measure), it is also due to the benefits of a weaker dollar (38% of revenue was earned abroad) and finally it is due to share-buy backs. However, it is the underlying trend that is most important. In the end it will be the underlying trend in profits that will dictate despite the fact that many of the larger S&P companies earning monopoly profits at the expense of the smaller corporations.

It is also noteworthy that on the same day corporate profits were released, the RUSSELL 2000 hit a new record. This is the market in shares for the smaller corporations. It shows that the tax cuts have created a haze obscuring real developments. It is testament to the adrenalin affect of the tax cuts. The question is posed what will happen when this rush wears off.

I am loath to provide turnover figures for the corporate sector because the BEA only provides GVA for corporate business, not Gross Output (GO) which is needed to complete the turnover formula. It does not provide GO on a legal basis such as the corporate sector, but only on an industry basis. Nevertheless, it is possible to obtain a proxy turnover rate by applying the share of total GVA produced by the corporate sector and applying it to the total Gross Output produced by all private industries. On that basis the formula can be completed. The turnover rate for the corporate sector is thus consistent if understated. It helps explain why corporate profits are in the doldrums. As long as the rate of turnover is falling, it will either accelerate the fall in the rate of exploitation or hold back its rise. As the mass of profits depends on the rate of surplus value, not on the rate of exploitation, then a relative fall in the rate of surplus value will depress the movement in profits, as Graph 2 below shows.

Graph 2.



(Source: National Income Table 1.14 for GVA and GDP-by-industry for Gross Output.)

The graph shows the growing diversion between the two rates with the rate of surplus value falling faster than the rate of exploitation. Until 2008 the rate of surplus value sat above the rate of exploitation because of the acceleration in the rate of turnover. Since then it has fallen below, especially since 2014. This explains why the current the mass of unadjusted profits in nominal terms is 19% below its peak and if we include inflation, it is down by over a quarter. It is unlikely that profits will scale their previous highs until turnover accelerates.

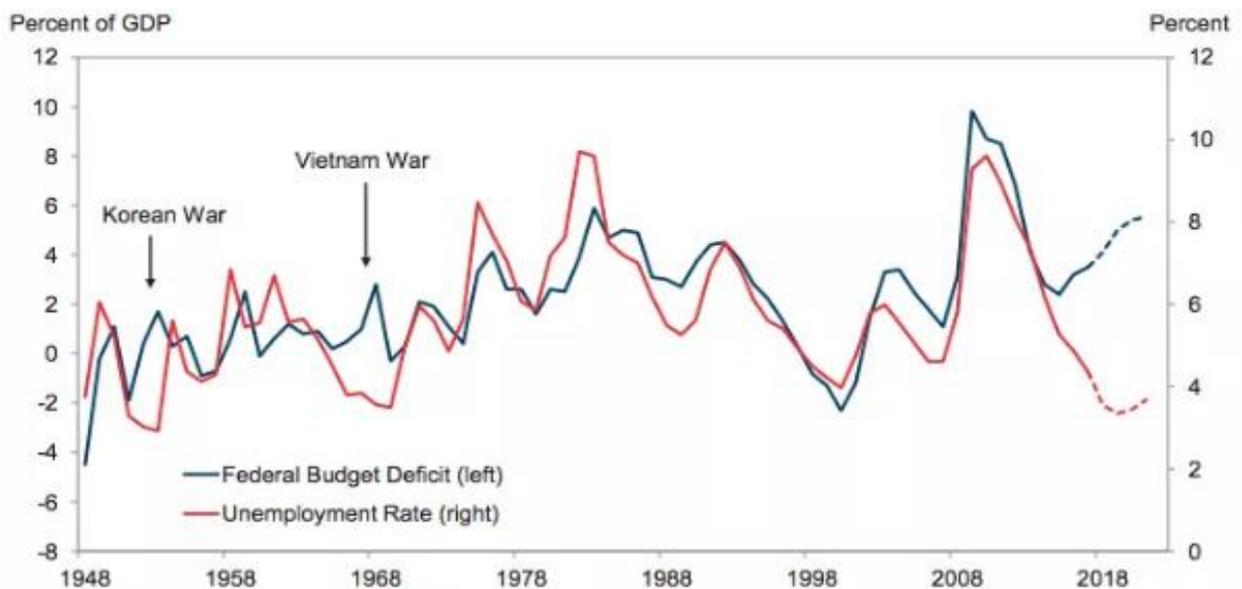
Short term gains versus long term losses.

It is generally agreed by analysts that the expansion is long in the tooth. One of the measures is the rate of unemployment. While the unemployment figures are unreliable and while the reserve army of labour in the USA has been generally rendered unemployable because of government neglect, it is clear that labour markets are relatively tighter by the standards set after 2008.

Graph 3 is an interesting graph which plots the divergence between the official rate of unemployment versus the growth in the US budget deficit following the December Tax Giveaway and increased military spending. It shows an unusual divergence currently between the movement in the fiscal deficit and the rate of unemployment. Indeed, the scale of the present divergence is unprecedented.

Graph 3.

Exhibit 1: Large and Rising US Deficits Are a Major Departure from Historical Norms



Source: Department of Labor, Office of Management and Budget, Goldman Sachs Global Investment Research

The US budget deficit is rapidly heading back to 8%. This year the budget deficit is likely to hit 4.0% or nearly \$0.9 trillion. This compares to 3.5% last year which means that the budget deficit increase will have added 0.5% to real GDP growth. (Congressional Budget Office April release). However, this figure is based on an overestimation by the CBO of real GDP growth, which means the current deficit could be closer to 4.5% than 4.0%. The CBO report basis its assumption of a 4.0% deficit on 3.3% real GDP growth for the whole of 2018. According to the FED's May *Beige Book* release, there was no acceleration in economic activity following on from the first quarter with the exception of its 6th District, Atlanta, which is centred on the oil industry. Hence if 2nd, 3rd and 4th quarter GDPs do not approach 4% then achieving the projected figure for 3.3% annualised growth looks highly unlikely.

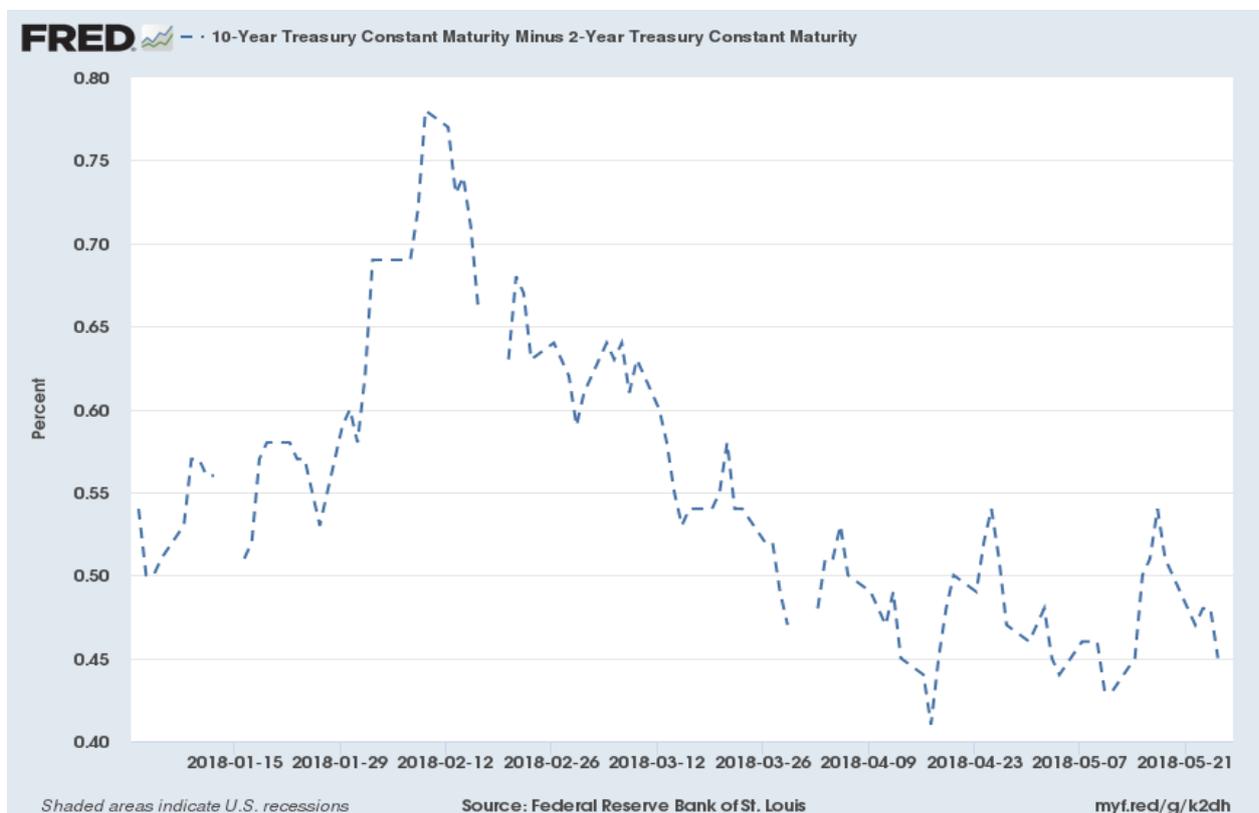
It should also be noted that the quoted CBO monthly report released on the 7 May shows that corporate profits have already fallen by 22.4% compared to the same period last year. This fall would have been more severe had the first three months of the reporting period not fallen outside the December change in tax law. Already corporate profits contribute a miserly 6% of tax receipts.

Despite a few wobbles, the government has not had many problems funding this growing deficit to date. Despite below average cover (how many times each issuance was oversubscribed), this cover has not fallen to crisis levels. This has allowed the issuance of government debt to run ahead of actual requirements with the result that the government has already built up a half-a-trillion cash buffer. This is quite interesting. Three possible reasons can be advanced. Firstly, that the government is expecting interest rates to continue to rise so is getting funding in early while rates are relatively low and is thus being prudent. Secondly, they are anticipating future funding problems where issuance is under-subscribed resulting in a spike in interest rates.

Or, finally, they are building this buffer to have sufficient cash to inject into the economy should there be another financial implosion. This should be seen in the context of the reversal of Quantitative Easing where the selling of previously held bond also provides an additional source of cash for the government. If it is the case that the government is squirreling away this hoard, then the outlines of a future bailout are becoming clear.

Interest rates have become increasingly volatile. After hitting 3.1% on the 17th May, the ten-year yield was down to 2.84% on the 1st June. The spread between two year and ten-year bonds continues to fall below 0.5% which is historically low. Such a contraction has been seen as a precursor to weaker growth in the future, though this indicator is currently less reliable, because of the effect on longer term interest rates caused by the unwinding of Quantitative Easing.

Graph 3.

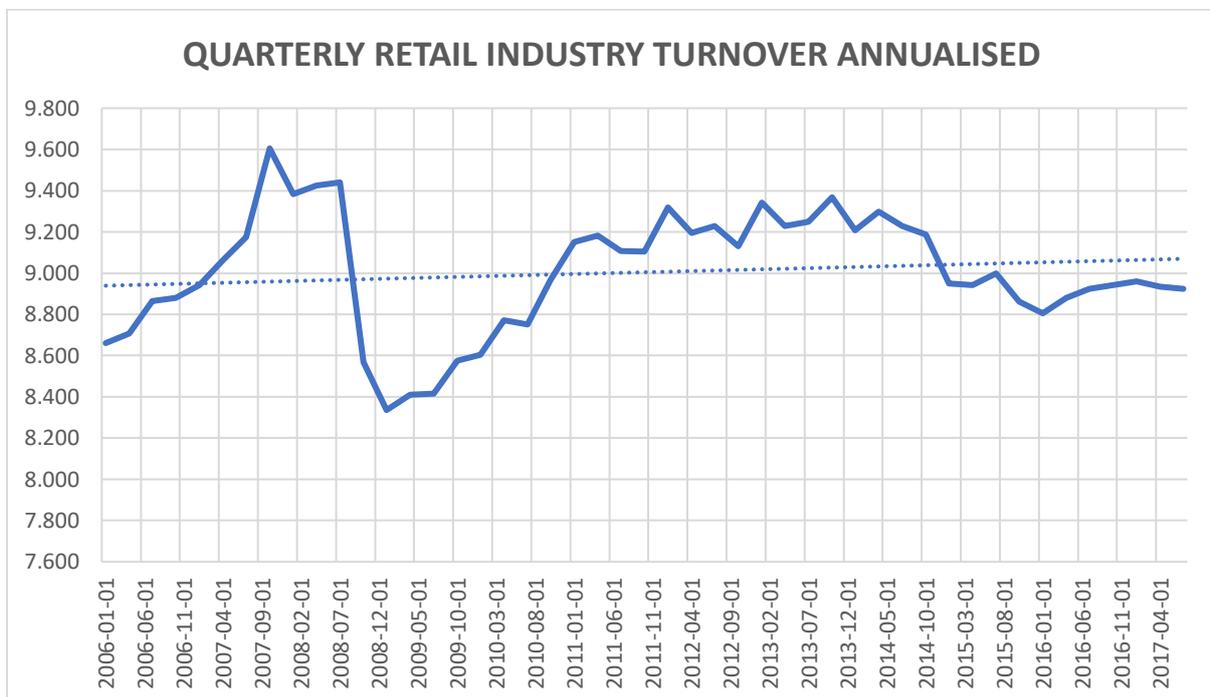


At around 2.9% - 3.0% interest rates act as a continuing break on spending. As examined below it has had a pronounced effect on durable good purchases. In addition, the fact that the ten-year bond cannot hold above the 3% mark for any period of time shows that investors expect weaker growth in the future despite the need for record issuance on the part of the Federal Reserve.

One of the expressed aims of the tax cuts was to improve consumer expenditure, firstly in the form of share-buy backs/dividends, and, by an improvement in take home pay. This has not happened. At the lower end the small increase in take home pay has been eroded by the increase in petrol prices, housing prices and health related costs, together with higher rates of interest. Table 1.2.5 (National Accounts) which lists final sales, shows the sales of goods between the first quarter of 2018 (when the tax was in effect) and the last quarter of 2017 (when it was not) rose by 0.2% or less than the rate of inflation. In fact, durable goods showed a fall of 1%. More specifically, the sales of new homes are down 4% from its recent peak and auto sales are broadly flat with April down and May up. Both industries are interest rate sensitive. What growth there was occurred in the service sector and as usual was centred on health and housing. The slowdown in consumer expenditure held back GDP growth in the first quarter and the May release of the Beige Book shows weak consumer spending has continued, though it is too early to be definitive for this quarter.

Another way of looking at consumer expenditure is to examine the rate of turnover in the retail “industry”. Generally buoyant conditions are associated with rising rates of turnover as the pace of retail accelerates. But as Graph 4 shows this is not the case, and, in contrast to manufacturing, which was shown in the previous posting on the US economy to be ticking up, the rate of turnover has decelerated in retail because it is more sensitive to interest rates.

Graph 4.



(Source: retail sales FRED tables RRSFS, Intermediate sales BEA Interactive Table GDP-by-Industry. Formula used is $RS+IS/GVA+([RS+IS]/GVA)/GVA$ where RS stands for retail sales, IS for intermediate sales and GVA for gross value added.)

As anticipated the tax give-aways at the top have not percolated down into the economy. This give-away tax was designed to benefit the top 1% or even the top 0.1% rather than those at the bottom. However, those at the top are already suffocating on too much money. Accordingly, it was always going to be the case that reduced tax for the rich would fuel speculation rather than increase spending, which it has.

The only element of growth that has occurred has been in non-residential fixed investment. Corporations pledged on the back of the tax give-away that they would increase their investments putting the US first. Whether the increase in investment (which has stimulated manufacturing), is due to the surge in the oil industry together with some FAANG corporate restructurings, or whether it is due to the tax give away, is difficult to discern. What is easier to discern is that falling profits are not conducive to rising investment, meaning that the current uptick in investment is temporary and unlikely to endure for more than one more quarter. When it falters, this will add to weak consumer spending making it even more unlikely that the economy will grow 3.3% this year. Trump will have done so much damage to the US economy that he has earned the nomenclature: “Megaton Trump”.

In summation, the tax cuts were unaffordable. They have provided little benefit to the economy except in terms of boosting post-tax profits which has fuelled speculation, by you guessed, providing more fuel for this in the form of share-buy backs and increased dividends. This has allowed the markets to remain buoyant meaning the adrenalin rush has not yet worn off, or put another way, the interest rates these cuts have provoked have not yet overpowered this stimulus.

The stock market is one where three investors, *Vanguard*, *Black Rock* and *State Street*, own 88% of all S&P 500 shares on behalf of clients, mainly through ETFs. This indirect ownership of shares encourages the gaming of the system. It also means the markets have less liquidity compared to the past. In addition, 50%, yes 50% of all S&P 500 companies are rated BBB or only one notch above junk. In a downturn, which will wipe out their precarious investment grade status, they will need to be dumped adding to the turmoil in the markets. In the event of another financial implosions, it is these trillion-dollar investors like Black Rock and their ETF funds that will become the new Lehman Brothers.

On this question it is interesting to note the effect that Trump’s tweets are having on the markets. A pattern is emerging of alternating tweets: first a negative one depresses the markets, then the following positive one elevates it. Clearly if speculators could find a way of gaining prior access to the content of these tweets, and by using leverage (derivatives) applied to high frequency trading, they could make quite a few “bob”. And even if they did not gain access, the resulting volatility is still good for speculation. It gives new meaning to a “business friendly president” or should we say: “banking friendly president”. Unpredictability certainly has its rewards.

A synchronised recovery gives way to one bump after another.

It is clear that the optimism of last year has given way to rising concerns about trade wars, military wars and political instability. One crisis subsides only for another to erupt. First it was squaring up to North Korea, then it was a run on the Argentinian economy, then a run on the Turkish Lira, then a run on the Euro because of Italy, then resurrecting ZTE or not, then retaliatory tariffs by Canada and the EU. Now it is US military posturing in the South China Sea as though it was the Gulf of Mexico.

One thing after the other. It is not the individual incidents that are important but the trend of rising incidents. They are multiplying not reducing. Such a trend signifies a destabilisation of the world economy. This is happening in a world economy that has become increasingly integrated. As Michael Roberts concluded in a recent posting detailing the rise in inequality: *“A dominant core of 147 firms through interlocking stakes in others together control 40% of the wealth in the global network according to the Swiss Institute of Technology. A total of 737 companies control 80% of it all. This is the inequality that matters for the functioning of capitalism – the concentrated power of capital.”* (<https://thenextrecession.wordpress.com/2018/05/15/rising-world-inequality/>)

Accordingly, fewer than 1000 multi-nationals and global banks dominate the world economy. When Britain voted to leave the EU to escape the servitude of Brussels, the masses were not told they would

swop this servitude for the servitude of the board rooms of these corporations. These corporations would devour an isolated Britain.

These corporations require weak nation states including China, India, Japan, the EU and the USA. In fact, they seek porous nation states bound by extra-national jurisdiction, an unaccountable and invisible global government holding individual nation states in thrall. The erection of trade barriers is an anathema to them. These barriers represent not only a challenge to globalisation, but they represent a growing contradiction between the emerging economic base of capitalism and the older political superstructure. What is becoming apparent is that it is the ageing and increasingly obsolete superstructure that is winning out, particularly when this is overlaid with the rising tension between the USA and China. Because the superstructure is increasingly incompatible with the base, it acts as a barrier to the restoration of profitable production thereby preventing an escape from the conditions created by the financial implosion in 2008 (an implosion which itself revealed just how inter-connected the world economy has become).

Nor can it be argued that machine learning and adaptive manufacturing is a way out of this predicament, an alternative to globalisation. While automation at the lower end makes wage differentials less important and while adaptive production allows for shorter production runs, they are not economic when compared to international production chains. What capitalism needs, and what is presented as a barrier of its own making, is to overcome the national peculiarities in a global economy that restricts production and adds to its costs.

Capitalism needs a global single market which is politically beyond reach. This begs the question as to how capitalism will deal with the nation state and the parliaments that represent these states in the future. It could be the case that in order to restore profitability, bourgeois democracy itself must be sacrificed on the altar of capital.

Brian Green. June 2018