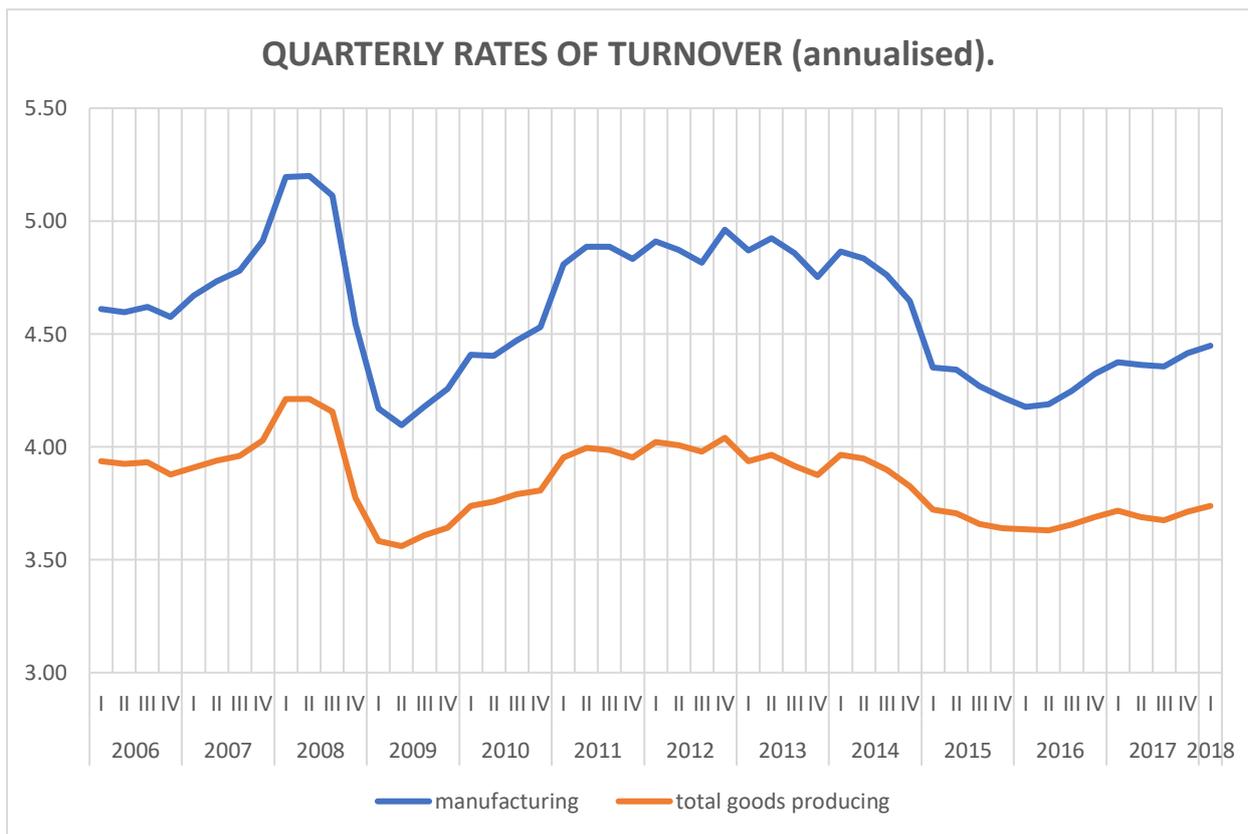


US ECONOMIC ANALYSIS FIRST QUARTER 2018 and global outlook.

This is the regular update on the US economy based on newly released quarterly data by the Bureau of Economic Analysis (BEA). This update looks at turnover in order to connect the rate of surplus value with the mass of profits. The growth in GDP of 2.2% for the quarter ended this March may have disappointed on the downside, but it still flattered the actual state of the economy. The quarterly rate of turnover barely improved and is still 10% or nearly 4 days slower than the levels found in 2013/14 (manufacturing). At this rate it will take another 10 quarters before it accelerates to the higher rate that obtained before 2007 and 2014. Until then it will have a restraining effect on the rate of surplus value.

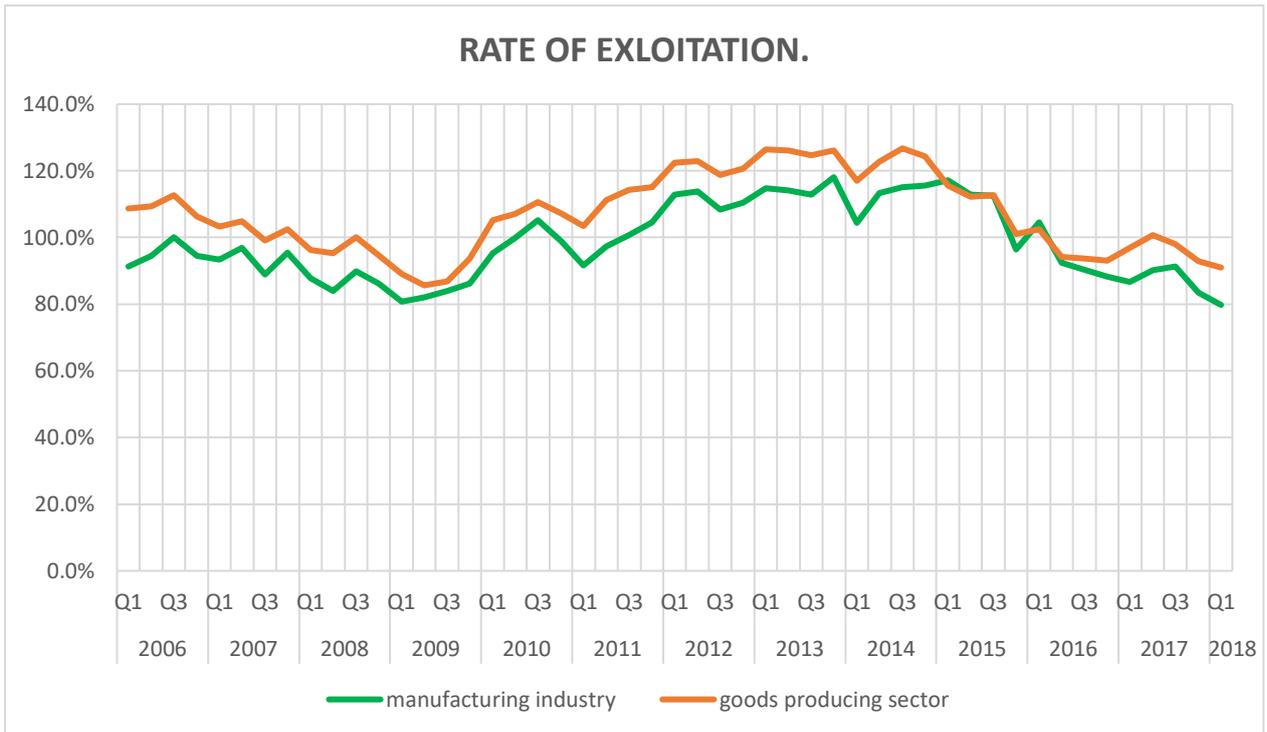
Graph 1.



(Source: BEA Interactive Tables, GDP-by-industry. Gross output and gross value added tables.)

The rate of surplus value has two components. The rate of turnover and the rate of exploitation. The rate of exploitation is based either on the surplus divided by annual compensation, or, a single period surplus divided by single period compensation. Both yield the same result. In determining the rate of exploitation, the surplus is divided by wages and salaries, because compensation which includes benefits is not available yet. As wages and salaries are a lesser figure this tends to overstate the rate of exploitation. To obtain the surplus, wages & salaries are deducted from the appropriate national income figure. The resulting surplus figure is then divided by wages and salaries.

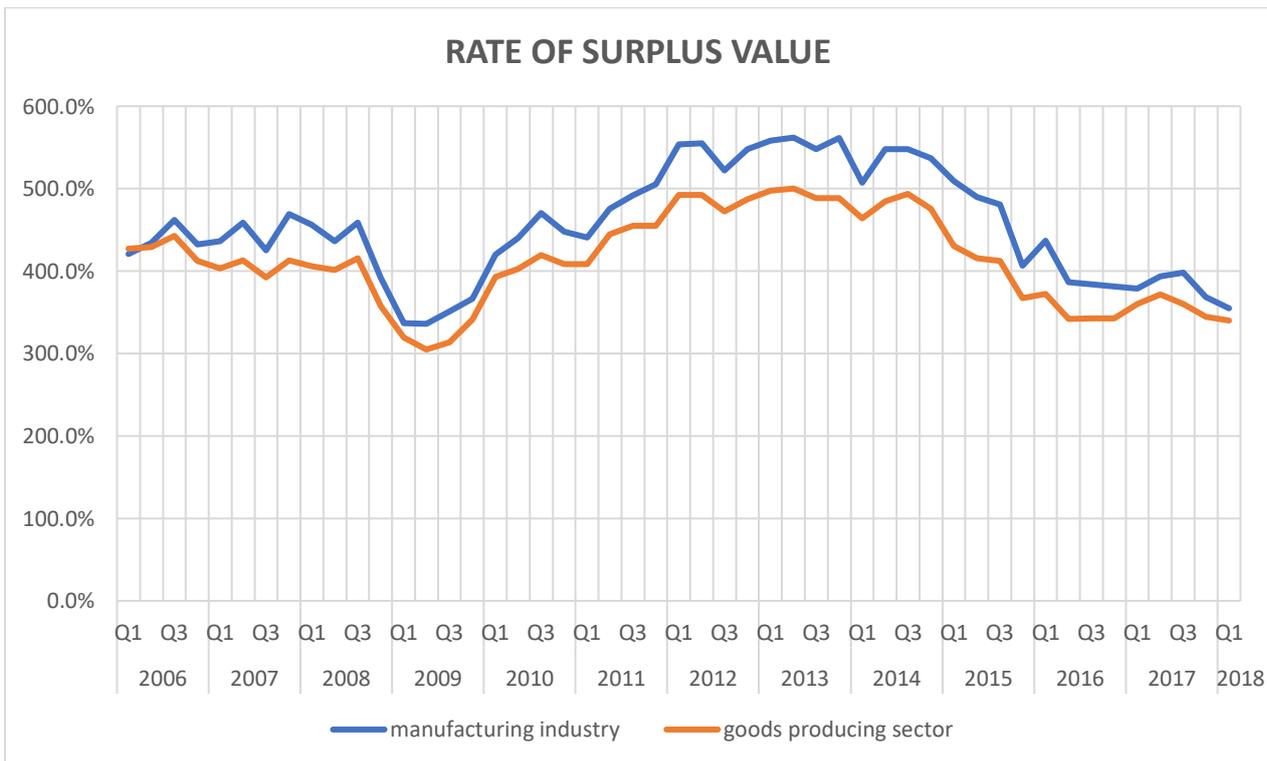
Graph 2.



Source: BEA National Income Tables. Table 6.1D for National Income and Table 2.2D for Wages and Salaries.)

By multiplying the rate of exploitation by the rate of turnover, the rate of surplus value is obtained and plotted in Graph 3 below.

Graph 3.



(Sources: as detailed in Graph 1 and Graph 2.)

The marginal improvement in the rate of turnover was insufficient to offset the fall in the rate of exploitation, resulting in a sharp decline in the rate of turnover which amounted to 4% for manufacturing and a 2% fall for goods production. The smaller fall in the goods production sector was primarily due to both the increase in both the volume and price for US oil production. Compared to the comparable period last year, oil prices at Cushing were 10 Dollars higher.

Turning to the Manufacturing Industry, the fall in the rate of surplus value had a predictable impact on the mass of pre-tax profits. At \$238.5 billion for the quarter, profits unadjusted for inflation, were nearly fifty percent lower than the end of 2014 peak.

Graph 4.

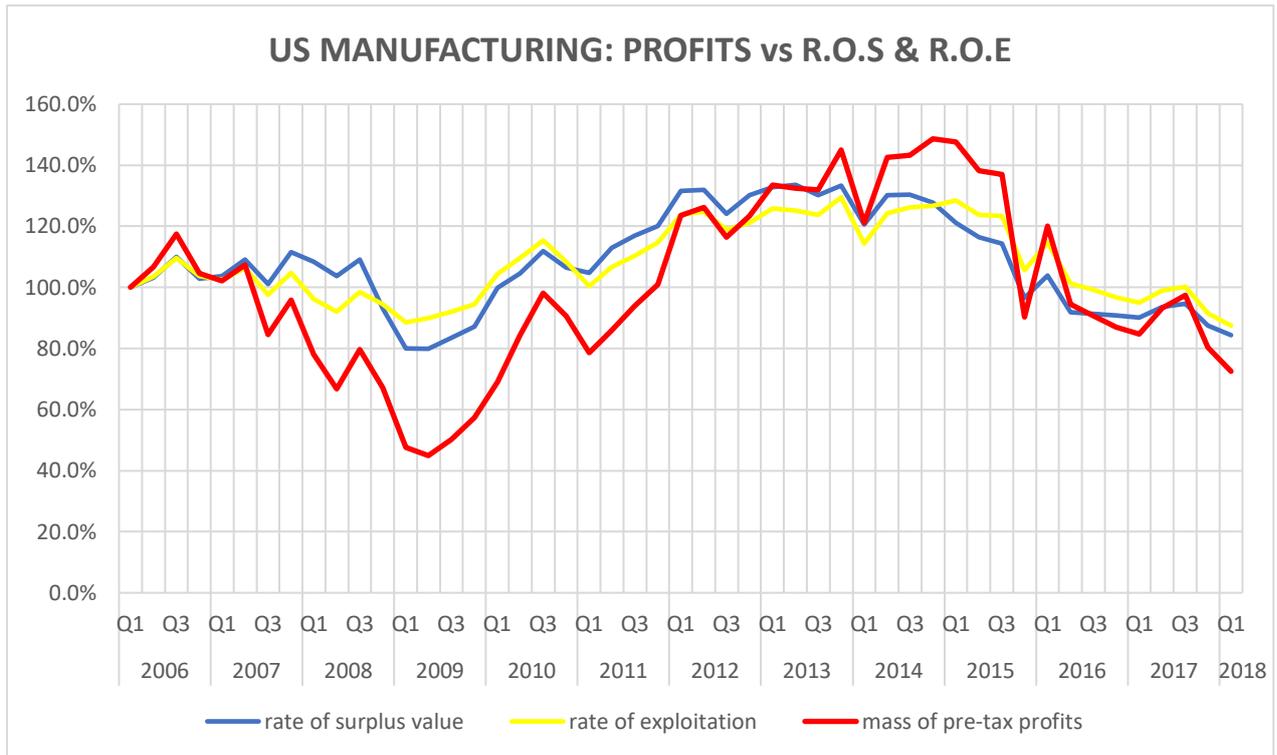


(Source: Table 6.16D. Corporate Profits by Industry with CCAAdj and IVA adjustments. Release date Jul 27, 2018.)

In Graph 5, a more detailed analysis is given for the movement of the mass of corporate profit. It details the interaction between the rate of exploitation (R.O.E.) and the rate of surplus value (R.O.S). The general rule is that when the rate of surplus value falls below the rate of exploitation the mass of profits trends down, and when the rate of surplus value rises above the rate of exploitation, the mass of profits trends upwards. The trough in profits in 2009 was accompanied by the rate of surplus value falling below the rate of exploitation, and, the rise in the mass of profits up to 2014 was accompanied by the rate of surplus value rising above the rate of exploitation in 2011.

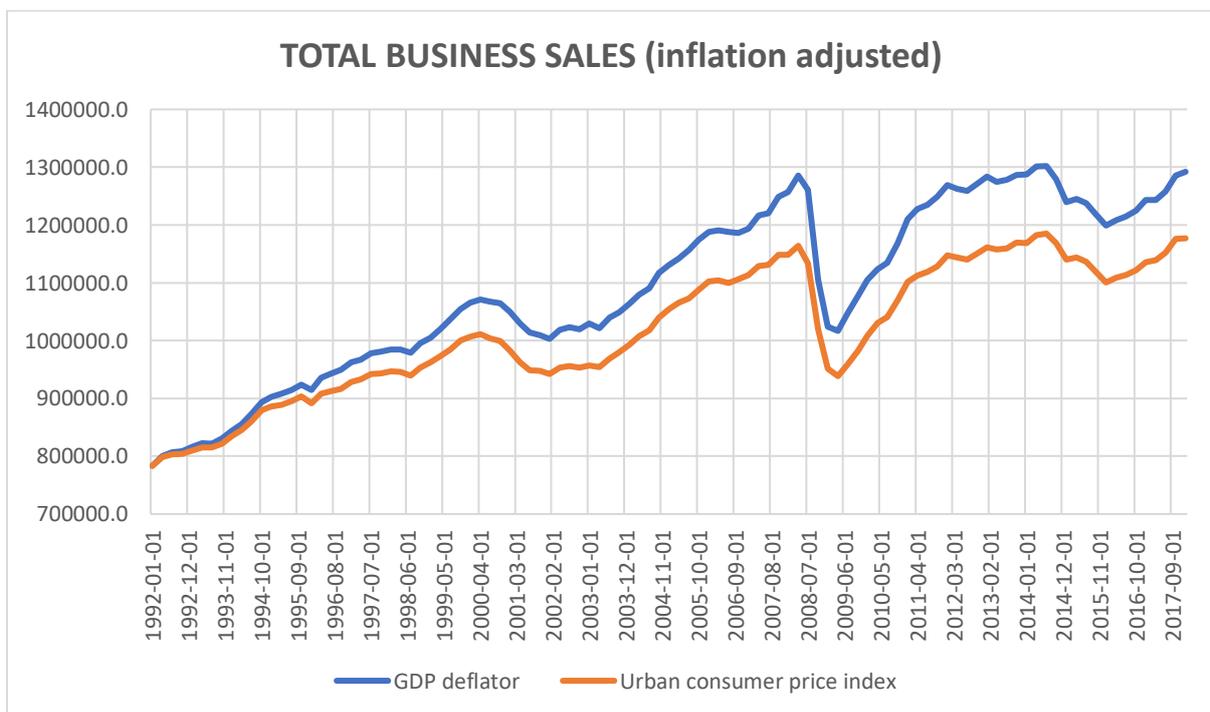
The sharp fall in the rate of surplus value at the end of 2014 forcing it below the rate of exploitation was the harbinger of falling profits thereafter. Currently the rate of surplus value remains below the rate of exploitation. Therefore, it is likely that any rise in the mass of profits will be subdued in the second quarter. Evidence of this rise is already present in the released data on productivity and labour costs in the second quarter (see Outlook). As long as the rate of surplus value is depressed, the current economic phase can and must be described as one of rising animation, and not prosperity, despite Trump’s swagger.

Graph 5.



One measure suggests that the period of rising animation has given way to prosperity and that is total business sales comprising manufacturing, wholesale and retail. This graph ends in March, but were it to include the second quarter ended June, then total business sales adjusted for inflation has finally surpassed its previous peak at the end of 2014.

Graph 6.



(Source: FRED Table TOTBUSSMSA for nominal sales and Table GDPDEF & CPIAUCSL for inflation adj.)

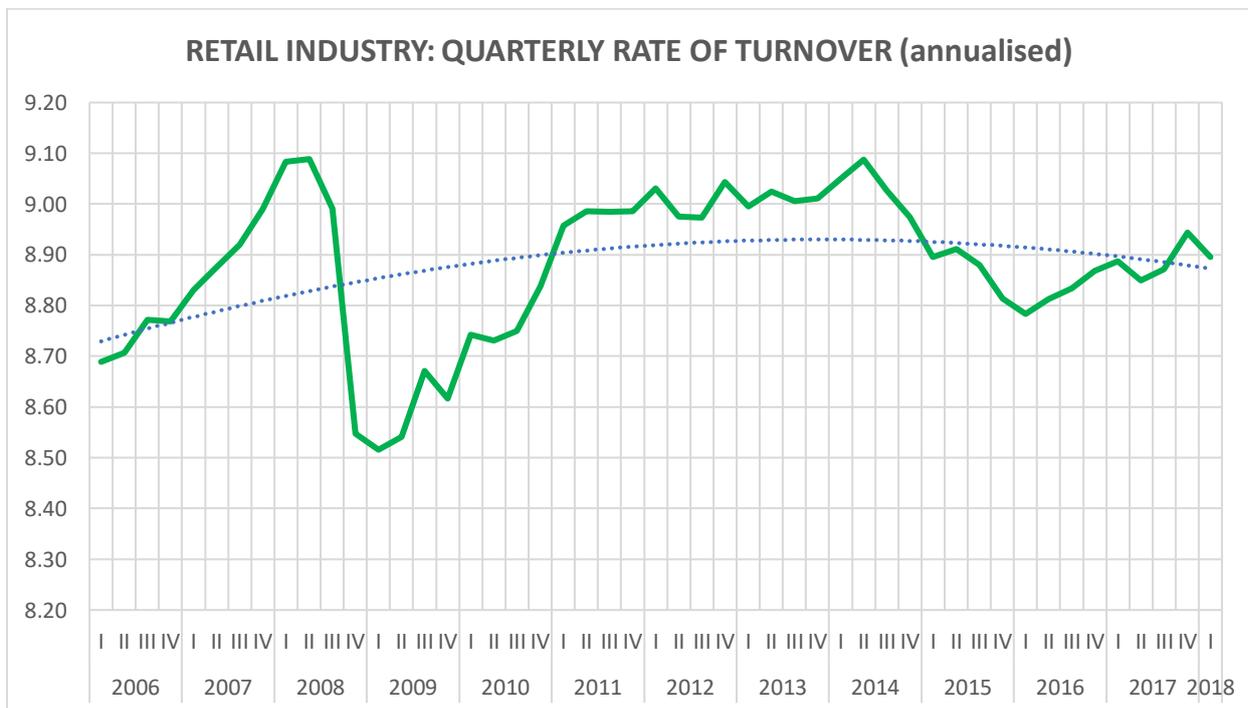
Here two deflators are used, one the GDP deflator and the other the urban Retail Price Index. Both measures yield similar trends. Obviously an incongruity exists between rising sales and falling profits. Two points need to be made. Firstly, there was a pickup in sales following the damage wrought by the hurricane season in the second half of 2017. Secondly, there was a further pickup this year due to the tax changes that occurred towards the end of 2017 which encouraged spending. However, and most importantly, the former two impulses will be short-lived and are one-off unless this season’s natural catastrophes resemble last year’s. Unless profitability picks up, and here we refer to pre-tax profits, not the post-tax profits boosted by the tax cuts, this increase in sales is unsustainable. The incongruity will be resolved either by sales growth being arrested or even reversed or a sharp improvement in underlying profitability. (See Outlook) The former is more likely as July’s data has shown.

The rate of turnover for the economy as a whole.

It is my intention to always include the rate of turnover for the retail industry in these reports. I consider this rate to be representative of the productive economy as a whole. The gross output for retail equates to approximately 20% of private industry or 25% of the business sector. The formula for the retail industry is a modified version of the turnover formula due to the exclusion of sales of merchandise in gross output. The BEA does this to avoid the duplication of sales taken elsewhere, for example, in the manufacturing sector which sells to the retail sector. The only sales it takes are those within the industry or from other industries which serve as inputs. Therefore, in order to obtain the real gross output, the sales of merchandise is now taken and added to the intermediate sales consumed within the industry itself. The formula is described thus: RS stands for Retail Sales and IS for Intermediate Sales allocated to the retail industry.

$$\frac{RS + IS}{GVA} + \frac{(RS + IS) - GVA}{GVA}$$

Graph 7.



(Source: BEA Interactive Data, GDP-by-industry for GO and GVA. FRED Table RSXFS for Retail Sales See link on site page for worksheet “GO quarterly up to Q1 2018”)

Since the beginning of 2016, the rate of turnover has risen more sharply than for manufacturing. It manifests an improvement up to the 4th quarter of 2017 in line with brisker sales followed by a significant fall in the first quarter of 2018. Half its fall since the second quarter of 2014 has been reversed. In terms of days, the two days added to the period of turnover has been reduced to one. It is expected that the fall in the first quarter will be more than reversed by buoyant sales in the second.

The outlook.

The outlook for the mass of profits in quarter two is for a +5% real improvement. This is predicated on positive data already released for productivity and labour costs.

Table 1. (BLS) Percent change from corresponding quarter of previous year

		Productivity	Output	Hours	compensation	labour costs	other costs	deflator	
2018	II	1.4	3.4	2.0	3.4	0.7	1.9	3.4	2.5
	I	0.9 r	3.1 r	2.2	3.1 r	0.8 r	2.1 r	1.6 r	1.9 r
2017 annual		1.1 r	2.6 r	1.5	3.4 r	1.2 r	2.3 r	1.0 r	1.7 r

There was a sharp improvement in productivity and labour costs compared to the previous quarter which raised annualised comparisons as well. In manufacturing there was a sharp improvement in quarterly performance but this time it was insufficient to lift annual performance.

Of course, this has not prevented analysts such as FactSet suggesting annual earnings per share should rise by around 25% this quarter buoyed by a reduction in corporate taxation and share buy backs. (https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_081018.pdf) If this figure is achieved it will be the second highest profit spurt since FactSet begun recording data. However, the previous high was not boosted by an expected \$1 trillion worth of share buy backs this year, nor the tax giveaway. The corporate tax giveaway has already resulted in a fall in corporate tax of \$66 billion in the first ten months of this fiscal year, compared to the previous fiscal period, a fall equivalent to 28.3%. That equates to 10% of the budget deficit due to come in at minus \$800 billion or 4% of GDP before rising to £1 trillion next year or around 5% of GDP. (<https://www.cbo.gov/publication/54339>)

However, capitalists, like all observant motorists, do not drive looking in their rear-view mirror. Instead they look forward through their windscreen. What concerns them is the outlook for profits not the history of profits. This outlook is now deteriorating for the first time. FactSet in the above quoted link, projects the number of corporations giving negative forward guidance as rising above the historical average: *“At this point in time, 74 companies in the index have issued EPS guidance for Q3 2018. Of these 74 companies, 55 have issued negative EPS guidance and 19 have issued positive EPS guidance. The percentage of companies issuing negative EPS guidance is 74% (55 out of 74), which is above the 5-year average of 72%.”* Much of this is clearly due to the uncertainty unleashed by Trump’s Trade War. This deteriorating outlook may be the reason why the USA has invited China to trade talks in Washington this month.

The growing concern about the outlook for profits is mirrored in an analysis by Eric Parnell who contrasts the outlook presented on the 26th April with the outlook presented on the 10th August 20 weeks later. All data can be found on the following link: <https://seekingalpha.com/article/4199947-day-stock-market-music-died?ifp=0>

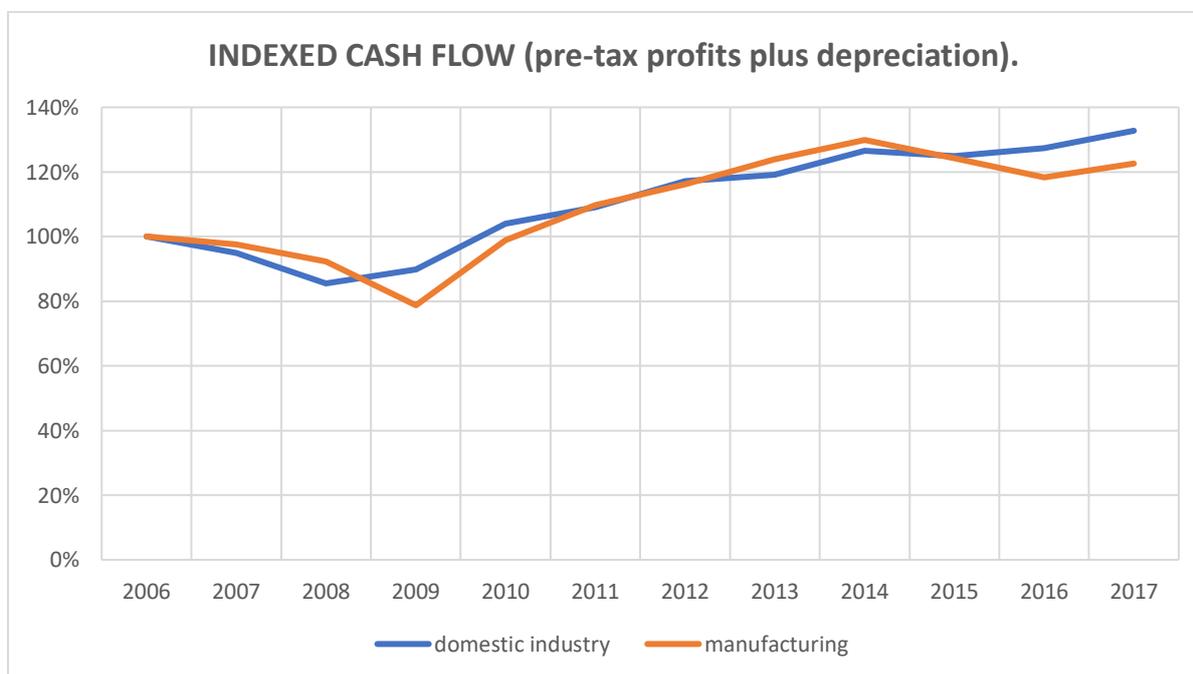
Table 2. Earnings per share (S&P 500)

PERIOD	April 26	August 10	Difference
2018 Q1	\$35.37	\$33.02	-6.64%
2018 Q2	\$37.78	\$34.22	-9.42%
2018 Q3	\$39.52	\$37.06	-6.22%
2018 Q4	\$41.56	\$39.36	-5.30%
2019 Q1	\$39.38	\$37.87	-3.85%

The most important comparison is that between the August 10 projection for 2019 Q1 and the original projection for 2018 Q1 of \$35.37. The difference of only 7% barely covers inflation and the volume of share buybacks. In other words, there is no profit growth beyond this year when the effect of the tax cuts falls away. And this is for the creative headline non-GAAP profit figure, not the more realistic figures presented by the BEA in Table 6.16D. Currently a gap of 20% exists between the forward EPS index and the trailing EPS index, which is supportive of share prices. When the forward projection of profit growth shrinks, then the trailing EPS becomes important and with it one of the central props supporting the market is kicked away.

Hence while the esteemed Lawrence Alan Kudlow, Trump's economic czar denigrates China, it has to be said that the US economy is vulnerable as well. Both are sailing into the headwinds of a debt crisis. Trump's adrenalin rush, the effect of the tax cuts, has no more than six months to run. Already July's data focused on the debt and interest sensitive car and housing markets, shows weakness. When it becomes clear that the trend for profits is now down, is the moment when interest rates assert themselves. Most importantly, because the US economy is trapped in the phase of rising animation, it remains highly dependent on outside financing. Despite the overstatement of depreciation, the fall in profits has resulted in corporate cash flow either falling from its high point in 2014 (manufacturing) or barely rising for the economy as a whole. (This data is not adjusted for inflation of around 6% between 2014 and 2017.) The trends can be seen in Graph 8 below.

Graph 8.



(Source: BE Interactive Tables 6.17D for pre tax profits and 6.22D for capital consumption allowances.)

In the period leading up to 2014, which must be characterised as one of prosperity, there was a sharp acceleration in cash flow. During this period industry met most of its own cash needs through internal sources, mainly a rapid rise in profits and depreciation. Since 2014, in real terms, there has been stagnation due to the fall in profits, but not depreciation, which has continued to grow. As a result, industry has become more dependent on external financing which initially was lubricated by historically low interest rates, though these are now rising because of the increased demand.

Any further fall in profits will constrict cash flow, and should interest rates continue their upward trajectory, the conditions will be opposite to those that existed at the end of 2015 and the pseudo recession. Then the FED deliberately held back interest rates preventing the outbreak of a full-blown recession. They should have. Since then total corporate debt has risen to over \$9 trillion much of it loaned out to corporations with ratings no better than BBB.

In hind sight the FED may have wished it had not intervened to keep interest rates down in 2015 because the conditions prevailing in 2018 are more ominous. By some estimates, corporate debt has risen by over 50% in real terms since 2008. In summation, the fact that the US economy remains trapped in the phase of rising animation, therefore with a dependency on external funds, it is vulnerable to any deterioration in profit and/or rise in interest rates.

BREXIT.

Britain is riddled by tragedies. Take the BBC. Many licence payers can barely afford the fee used to fund the BBC, which is then used to lie to them via the beguiling voices of presenters paid hundreds of thousands of Pounds for their services. Similarly with Brexit. The desperation created by austerity is “what done it” and won the vote to Leave. This is decisively analysed by Thiemo Fetzer in his paper *Did Austerity Cause Brexit*, posted this June, by the University of Warwick, Department of Economics. (https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/381-2018_fetzer.pdf)

Here we have the most deprived sections of the working class, those who have lost the most by way of austerity and globalisation, being seduced into the argument that their lives will be improved by leaving Europe and taking back control. The seducers of course are the very globalists that have undermined the lives of this section of society. What really gives the game away is that these rich men and women do not pay their taxes in Britain. They all hold off-shore accounts. The question is therefore posed, if they do not support Britain with their taxes, then their loyalty to Britain has to be questioned, especially on the streets.

If we set aside the nostalgic fools within their leadership ranks - the decoys - the real ambition of the Leaver leadership is to crush nation states, not rebuild them. They oppose regulations, they support privatisation and above all they support the right of the global corporations to rule us. They oppose the EU because it is a regulated market, one which may impinge in time on their de-regulated tax habits. What they seek is to disrupt the single market. It is not only about Britain but the EU itself. They seek a chain reaction. Their hidden goal is to create an isolated Britain which will be easy prey for the global corporations.

Their strategic aim is not to abolish single markets but to create a global market shorn of national peculiarities. Truly, an epic race to the bottom. A global market where national boundaries have been bulldozed and where regulations have been flattened. This is why they are so keen on WTO rules.

They see the WTO as the agent for achieving this goal because the WTO is a supra-national organisation. The kind of organisation that towers over the nation-state. The kind of organisation that rules out national rules. These gentlemen and gentlewomen, really vicious rogues, seek to strip the nation state of its legislative role and replace it with off-shore legislation, made in secret (Brussels will blush), and where the economic penalties for violating it by any nation will be so severe, that it will amount to national insolvency.

These globalists seek to set legal frameworks globally stripping national parliaments of any right to veto them. They have let all this slip in their bilateral negotiations like TTIP where arbitration is located on some hidden tax island beyond the reach of any democratic oversight. In this regard, Brexit was to be the test case. A small island in a capitalist ocean, groomed by the multi-nationals and the global banks.

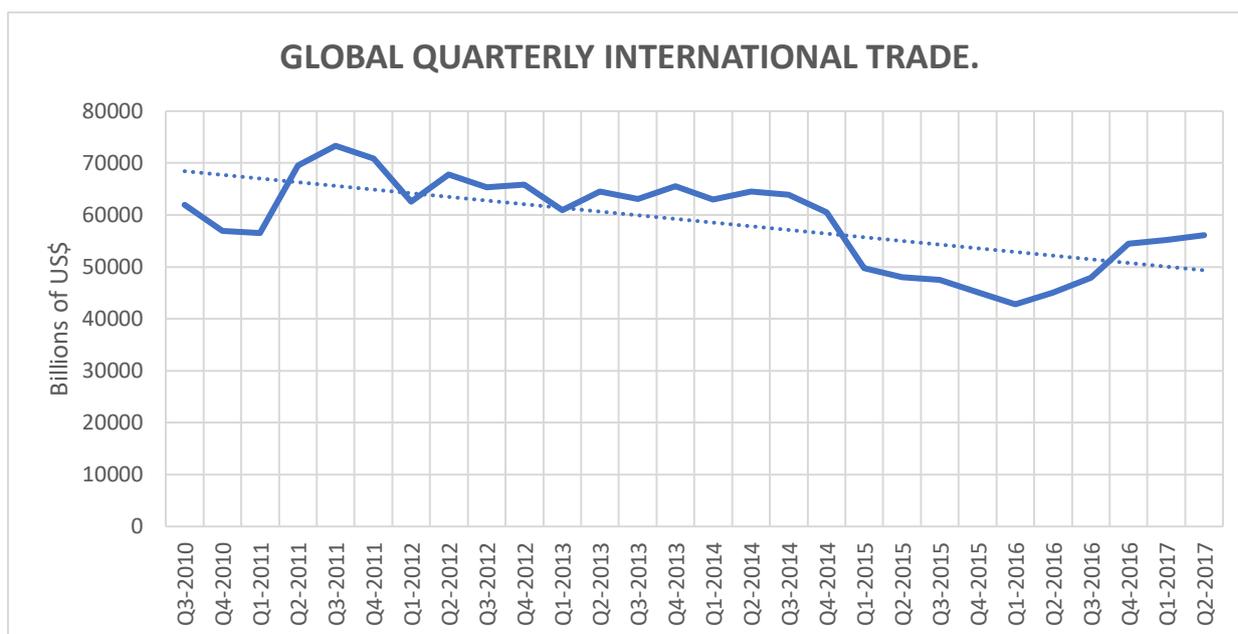
In reality it was not so much a question of taking control but giving control to the globalists. Except that the project is beginning to fray at the edges. Many of those who supported Leave are now beginning to question their support as the economic consequences become clear and the recklessness of the extreme Leavers becomes apparent. This is particularly true for the 6-8% who voted to Leave as an act of political protest. This shift in opinion has been carefully analysed and presented in the *Observer* (12.08.18) which has revealed that a hundred constituencies which originally voted Leave, have shifted to Remain. If a deal could be struck with the EU over migration, then it is likely that a second referendum will be called with a majority voting to stay in the single market.

The fact that May still presides is testament to the splits in the British Capitalist Class which has paralysed the Tories. A split which is mirrored in the global capitalist class. Many capitalists are not convinced by the disruptive policies of the globalists. Where the globalists see profit, they see disorder. They are terrified by the prospect of Britain crashing out of Europe without an agreement. Hunt, the foreign minister personifies this dilemma. On Thursday he states that leaving with no deal "*would be a mistake we would regret for generations.*" On Friday he says the opposite: Britain would "*survive and prosper*". That Hunt's right brain and left brain are disconnected is not an aberration. Hunt is essentially a globalist, the health minister overseeing the privatisation of the NHS and opening it up to the predatory globalist medical insurance companies.

In the meantime, the inept Prime Minister hurtles towards the deadline with the Leavers and Remainers fighting for control of the steering wheel. On the opposite side the leadership of the Labour Party is also fighting for control of the steering wheel as Zionists run in front of the car throwing anti-Semitic mud at the windscreen forcing the party to swerve all over the road. This mud-slinging has many advantages including distracting and preventing the Labour Party from exploiting the divisions within the capitalist class over Brexit.

Of course, it can be argued that the globalist tendency remains marginal at this time. But that is because we stand on the near side, not the far side, of another global economic crash. It can also be argued that technical developments favour national markets rather than global markets. The rise of advanced automation and the rise of adaptive manufacturing makes freight an increasing cost. Better to locate near the end user and enjoy a faster response time to changing consumer needs. The decline of international trade, as plotted in the graph below, appears to confirm these trends. (More up to date limited data by the IMF shows an improvement in the value of international trade due to the improvement in oil prices.) However, these declines are also a function of an anaemic world economy and price movements. They are not necessarily representative of the volume of world trade itself. According to the *WTO World Trade Statistical Review 2017*, the volume of world trade continued to grow. (https://www.wto.org/english/res_e/statis_e/wts2017_e/WTO_Chapter_03_e.pdf)

Graph 9.



(Source: OECD annualised trade statistics, <https://stats.oecd.org/Index.aspx?DataSetCode=QITS#>)

While these arguments have some merit, there is a more fundamental argument in favour of global markets. The accelerated automation of production combined with its extended reach, is devaluing production at a faster rate. To compensate for the fall in value, capitalism has always sought to increase the volume of production. This is nothing new. It lies behind the growth of all mass markets and their economies of scale. Only this time it is more urgent, driving the international centralisation of capital, resulting in a handful of global companies dominating each industry. These global corporations in turn require a standardised global market, or should we say, a levelled world market.

China.

China is an anathema to the globalist. The world's biggest industrial economy by some margin is riddled with state capitalism, the polar opposite to the globalist desire to privatise every asset and commodify every aspect of life. Privatising the Chinese economy today would surpass, by many orders, the privatisations that occurred after the collapse of the USSR.

In a recent article I posed the question whether China's economy was deflating under the burden of debt. (<https://theplanningmotivedotcom.files.wordpress.com/2018/07/chinas-debt-problems-need-to-be-resolved-pdf.pdf>) Recent evidence suggests a slowdown. Mention was also made of its technological vulnerability. To this can be added the continued domination of the dollar as the world's de facto reserve currency allowing the US to weaponize its currency. This was the self-same tactic used by the US against Japan in the second half of the 1980s when Japan was vulnerable because of its bloated property market. In contrast the US had already gone through a radical and painful restructuring of its economy in the early 80s and was embarking on a programme of technological renewal.

There are parallels with China today except in the realm of technology where Japan was self-sufficient at the time. In some ways China is more vulnerable and in others less vulnerable. It's debt load and technological backwardness makes it more vulnerable. On the other hand it's monopolisation of the global production chain together with being home to the world's largest consumer market makes it less vulnerable. In the 1980s, Japan's production was nationally centred whereas China's production

is internationalised. Anything that disrupts the Chinese economy would therefore not only lead to a lost decade for the Chinese economy, as happened to Japan, but a lost decade for the world economy.

In the interim the Chinese economy has manifested deflation. All the latest indicators have surprised on the downside. And it is likely that GDP is now on track to fall to 6% and below. This is driven mainly by a subsiding rate of fixed investment as the ten-year graph prepared by TradingEconomics shows. This fall in investment which propped up so much of the world economy is undermining industrial prices such as the price of base metals. Dr Copper, which measures the health of the world economy is down 25%.

Graph 10.



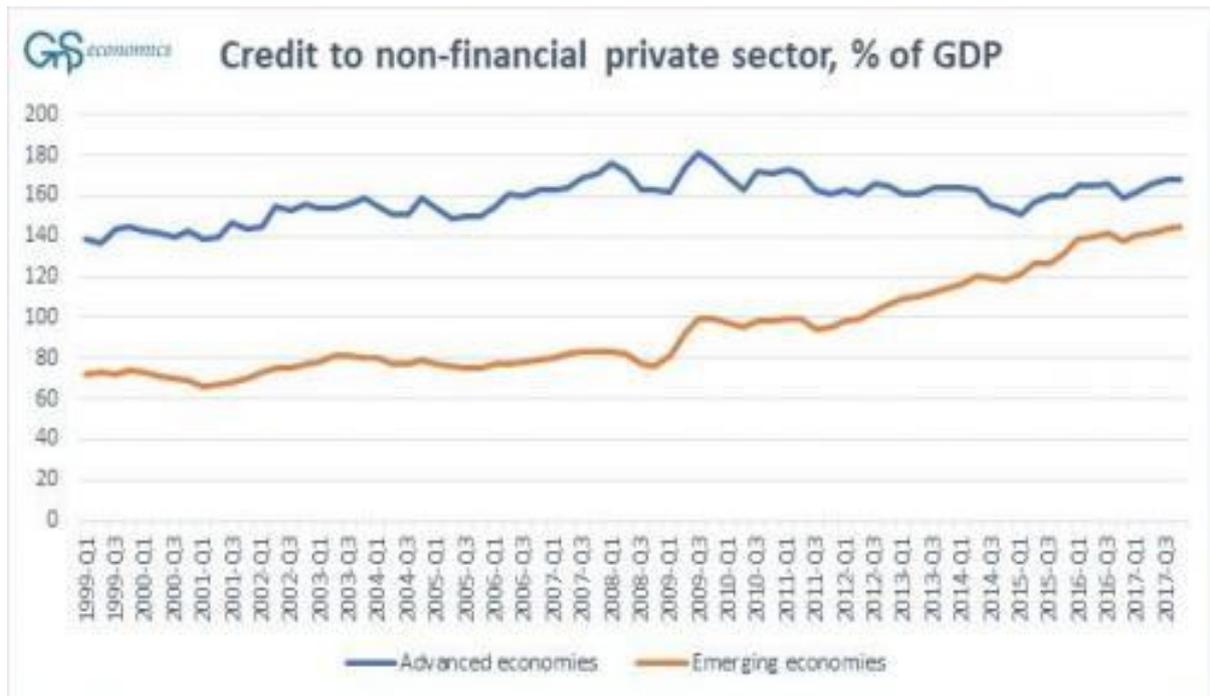
It is clear that both the US and China need to defuse the trade war. Neither is in a strong position despite the rhetoric emanating from the White House. Nor can the US rely on its ability to weaponize the dollar in the long run. Both the EU and China now have an urgent interest in making the Euro and the Yuan international currencies capable of undermining the dollar's status. At present the US is considered a safe haven which is why the 10-year yield has retreated below 3% despite a surge in issuance in line with the growing budget deficit. (It is also the reason for the compression in rate to 0.25% between the 2 and 10-year rate.) But, it is precisely this growing fiscal deficit, which is being financed by foreign money, that will in the end make the dollar vulnerable, possibly toppling it.

In conclusion.

Since interest rates began to rise 18 months ago the question was posed, could the world economy survive there rise? For a while the answer appeared to be affirmative. Confidence grew as synchronised growth took hold. However, this was short lived. Currently the economic mood has darkened. In China, monetary tightening had to be abandoned as growth and investment slipped faster than anticipated. In the US, the contradictory fiscal and monetary stances are beginning to disrupt the economy. In the EU centrifugal forces are once again taking hold.

Stresses are always felt most acutely in the weakest links in the financial chain, in those emerging economies (EM) who have borrowed the most on international markets, relative to their ability to repay because of their trade deficits. Interestingly, it is EM economies who are responsible for the growth in corporate debt worldwide not developed economies as Graph 11 below shows.

Graph 11.

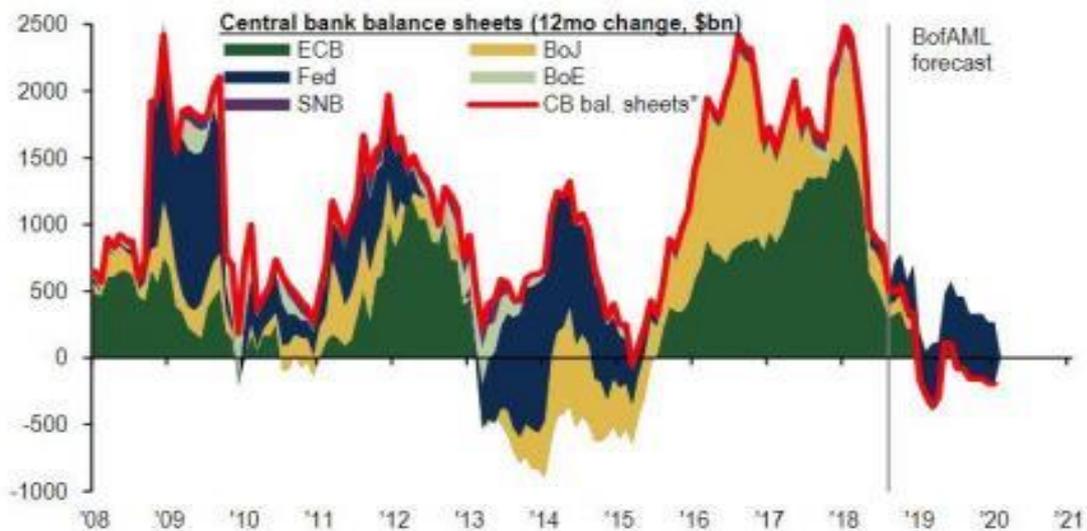


While credit within the developed economies has oscillated between 150 and 180% over the last ten years, credit within emerging economies has risen from around 80% to over 140%, an increase of two thirds. This is mainly due to China.

Countries like Turkey with their large dependency of foreign loans which cannot be financed by a trade surplus are particularly vulnerable, a vulnerability exploited by the US. Turkey is the bird in the coal mine. It together with much larger countries like India, are reeling from tighter financial conditions and a drying up of dollar liquidity as the FED reverses its quantitative easing and buys back dollars.

Graph 12.

Chart 5: The coming contraction of global liquidity



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg;

Graph 12 vividly demonstrates the growing liquidity crunch that will occur next year as the FED sells assets for dollars and as the US government is forced to issue \$1 trillion in extra bonds to cover the growth in its deficit from 4.5% to over 5% of GDP. This will represent a loss of financial support amounting to \$2.5 trillion and it will hurt the finances of EM countries.

However, the graph needs to be put in perspective. It excludes the main source of financial liquidity, that provided by commercial banks, and, it excludes China. China has recently reversed its tightening as conditions deteriorated in its economy. However, increased Chinese central bank liquidity has less of an impact on world financial conditions because of the limited role played by the Yuan.

In addition, the size of EM exposure needs to be put into perspective. Total EM foreign funded financial exposure stands at \$4.8 trillion. Of this sum, two thirds is held by China. The balance of around \$1.6 trillion is not much larger than the total student debt in the US amounting to \$1.48 trillion and growing by the month, and, where the delinquency rate is 11.2% (<https://studentloanhero.com/student-loan-debt-statistics/>).

While the first tremors have appeared in EM markets, these are only the foreshocks. The real earthquake will take place in the developed economies, most likely the US or China. The probability is increasing. The best of the tax adrenalin rush appears to be over with the high point reached in the second quarter. It is also unclear whether easier monetary conditions in China will be sufficient to arrest the slowdown in production. Much depends on the meeting between US and Chinese officials over trade scheduled this month. A compromise is likely based on the US watering down its aggression and China making additional concessions. The question is whether this will be sufficient to restore confidence to the markets.

In sum, it is likely that turbulence will increase in the world economy, and when it becomes clear that US headline profit growth is over, this turbulence will gather force. We are approaching the point where the question will finally be answered, can the world economy withstand rising interest rates?

Brian Green, August 2018.