

TRUMP, APPLE, TRADE WAR AND THE MARKETS (including the rate of profit updated to 2017).

This posting was held back pending Apple's reporting of its quarterly revenue and profits. Apple has now gone dark - it is no longer going to report volume sales of its devices. This news has rattled the markets. Apple is the bellwether for the market and its revelation sums up the exhaustion of the FANG business models (with the exception of Amazon). This posting also includes rates of profit updated to 2017. These rates show how important it is to include circulating capital alongside fixed capital in determining profitability.

On Thursday, after the markets closed, Apple Inc, the most valuable corporation in the world announced its quarterly results. Prior to the release Trump tweeted that he was in talks with China to resolve the trade war. *"Just had a long and very good conversation with President Xi Jinping of China. We talked about many subjects, with a heavy emphasis on Trade."* Trump knew full well that a market crash on Friday could sink Republican chances in the primary. He also knew that the combination of a disappointing report from Apple together with fears of a trade war could have capsized the markets sinking Republican prospects on election day. His pre-emptive tweet must be seen in this light, a fake "end to the trade war" to temporarily support the markets until November 7th when war will resume.

The US remains fixed focused on corralling the Chinese economy. It soon became obvious that Trump had not informed his cabinet of his exchange with Xi. *"There's no massive movement to deal with China," Kudlow, the director of the National Economic Council, tells CNBC's "Halftime Report on Friday* by which time Apple was down 7% and the markets between 1 and 2%. This contradiction by the influential Kudlow shows that Trump's tweet was nothing more than political opportunism, revealing once again how shallow his approach to politics is.

Apple Inc.

For a year I have been writing that Apple is a one card trick corporation. Now it is a busted flush. The one card trick was to raise the price of its high end, delicately pretty iPhones. Hence higher prices would compensate for falling volumes. But this could only be done once. After that comparisons fall away. Hence the next quarter's comparison with 2017 will be blighted by the earlier introduction of the much more expensive X phone last year.

Apple is now trying to pull the same stunt with its iPad and Mac computers by raising their prices. In this case it will simply lead to falling sales because the loyalty to these devices is lower than that for the iPhone. Has anything really changed propelling Apple towards becoming a service company rather than a hardware company? On the surface, no. If we view the data summary linked below, which incidentally is the last, we find the following: Revenue in 2018 Q4 was \$62.9 billion comprising sales of phones, computers and tablets amounting to \$48.7 billion or 77.4%. In 2017 Q4, the share of hardware sales was 80.2%, and insignificant difference. But, if we include ear phone, TV, speaker and especially its watch, all lumped under the category "other", then the difference disappears altogether. Services remains at 6.5%. (<https://www.apple.com/newsroom/pdfs/Q4-18-Data-Summary.pdf>)

There is thus no technical reason to shift to a services company. It is merely a sleight of hand to disguise the fact that Apple expects sharper falls in unit sales in the future. This has been recognised by most analysts who question Apple's motives. But there is more to Apple's gamble than this. Apple is orientated to the top 10% of earners and wealth holders around the world. This is predictable given that their discretionary spending power is equal to the bottom 80% of society. In this Apple is not alone. If we examine the car industry the same approach is evident. In the USA, the fall in unit sales

has been compensated for by the increase in sales of top end models. The result is that in October, while car sales fell 9% compared to last year, truck sales rose by over 5%. In revenue terms, the average transaction price rose by 3.1% to \$37,007 a gain of \$1,118 due to the changing mix of sales (Automotive News).

This targeting of the top 10% is not without its risks. This class is highly dependent on capital gains. In the period of expansion, the easy money which inflated asset bubbles, gifted this class with capital gains which fed into their spending. The converse will happen when asset bubbles deflate because of the inordinate dependency of the world economy on this inequality. *“Deutsche Bank's Craig Nicol calls “a quite fascinating statistic” namely that as of the end of October 89% of assets that Deutsche Bank collects data on for its annual long-term study, have a negative total return year to date in dollar terms. This is the highest percentage on record based on data back to 1901, eclipsing the 84% hit in 1920”* (quoted in *Zerohedge*) This figure compares starkly with the 1% hit in 2017. In other words, unless there is an extraordinary rally in most assets by year end, in 2018 the top 10% will be less wealthy than they were in 2017 and this is bound to reduce their “unproductive consumption”.

The rate of profit in 2017.

The rate of profit is not s/fc where s stands for surplus and fc for fixed capital. That is the rate of return. It misses out an important element equal to 30% of fixed capital and that is circulating capital. The rate of profit is a three-legged stool, not the unstable two-legged stool whose avoidance is advised. The rate of profit has to stand on surplus, fixed capital and circulating capital, if it is not to topple over.

This will be shown in the graphs below. It may be argued that the rate of profit shares the same trend as does the rate of return. Indeed, it does, but this is because it shares the same numerator, the surplus, and that is all. It certainly does not share the same denominator, which means that the rates tend to differ significantly in absolute values.

Why is this important? Both the trend and the absolute values goes into determining whether to invest or not. Capitalists have a threshold that needs to be met if they are to invest. A given rate of profit needs to be higher than the cost of capital together with inflation expectations, as well as providing a buffer against risk and providing for accumulation. If the rate of profit is rising, a lower threshold may be considered, and if it is falling a higher threshold will be considered.

The importance of just a couple of percentage points is demonstrated by its effect on the housing market. In Graph 1 below the 30-year mortgage rate is plotted.

Graph 1.



The cumulative effect of this 1.6% rise in mortgage rates to close to 5% has been traumatic. New house sales have plunged and with them, the fortunes of house builders. The fall in house sales is tracked by Graph 2 below. The highest fall of 18% y.o.y. occurred in California. The last time such a fall took place was in 2007 the year before the financial crash. *The S&P CoreLogic Case-Shiller Home Price Indices* are now registering month on month price falls for the first time, leaving annual increases trending towards the general rate of inflation. It means adjusted for the fall in volumes, in real terms, the aggregate money spent on residential purchases is falling.

Graph 2.

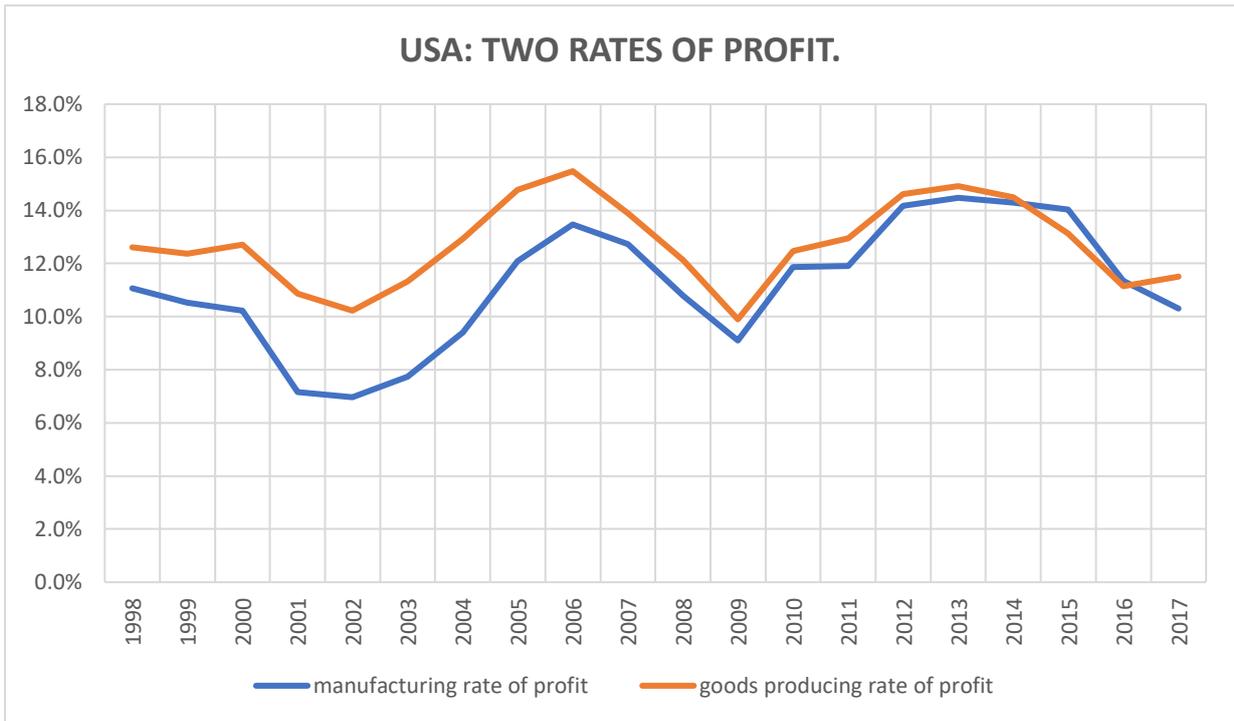


It is important to note that this contraction in sales and revenue is occurring despite tax cuts and share buy-backs peaking. This shows that mere 1.6% rise in interest rates was sufficient to crack the housing market. We can now turn to the rate of profit for 2017. Unfortunately, the BEA does not provide gross output for legally defined sectors such as corporate business. It only provides it on an industry wide basis. Without gross output it is impossible to isolate circulating capital. As a result, this article limits the rate of profit to the manufacturing sector and the goods producing sector for the rate of profit. All calculations and sources are to be found in the accompanying spreadsheet titled: [worksheet for r.o.p. 1998 – 2017](#) which can be found on the website.

I have used 1998 – 2017 as this is the period found in the BEA’s latest releases. The 20-year period provides a sufficiently lengthy perspective to illuminate today’s investment decisions. The first thing to note in Graph 3 is that the rate of profit fell in manufacturing while it increased in the goods producing industry. As the goods producing industry includes mining, that rise was mainly due to the rise in oil production with its \$20 a barrel price rise in the second half of 2017.

Both rates of profit remain below their 2014 peak. Goods producing is down 23% and manufacturing is down 29%. Manufacturing fell to within 1.2% of the low point achieved in 2009 at the height of the financial crash. The outlook for 2018 is mixed, a stronger first half followed by what is already a weaker second half, meaning no significant change to 2017 is expected.

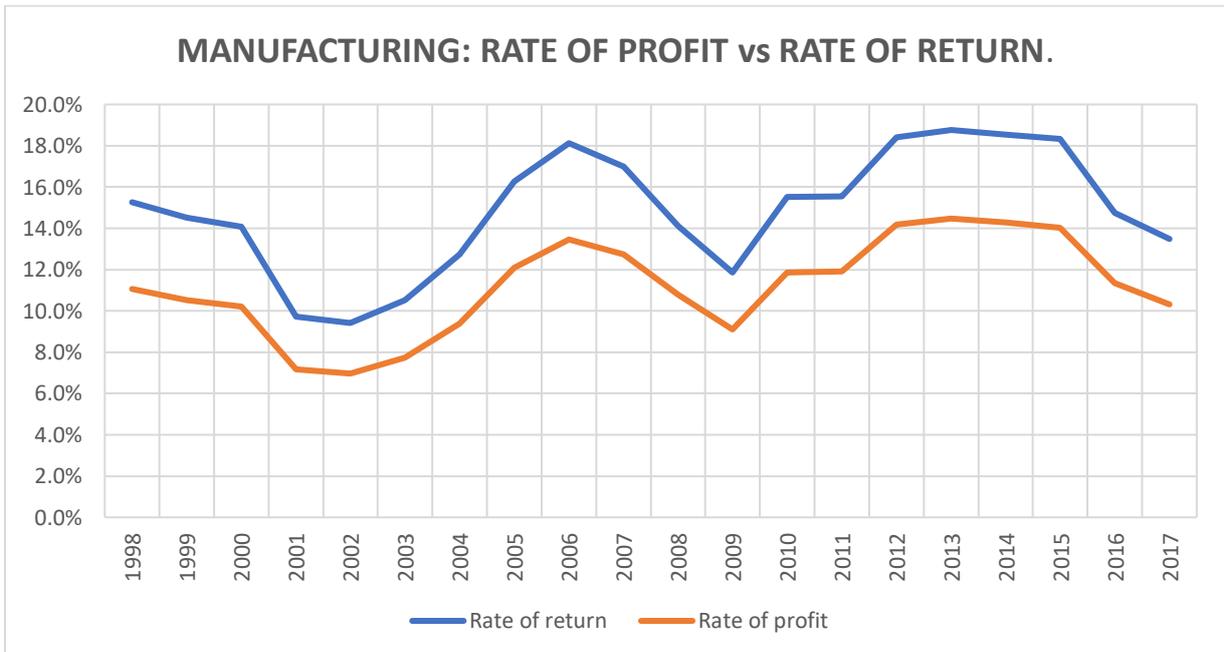
Graph 3.



(Sources: see spreadsheet.)

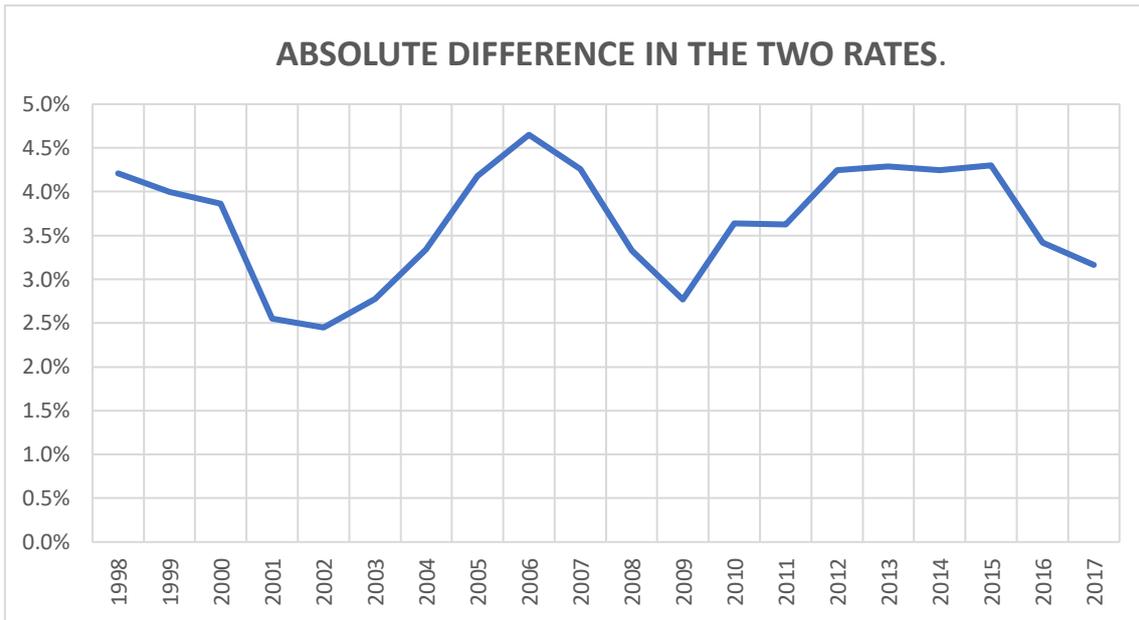
Graph 4 below compares the rate of profit to the commonly used rate of return.

Graph 4.



We note the difference in the two rates. The rate of profit is significantly lower. I have pointed out previously that in the peak years the gap between the two rates of profit increases only to contract in trough years. This movement is revealed in Graph 5 below.

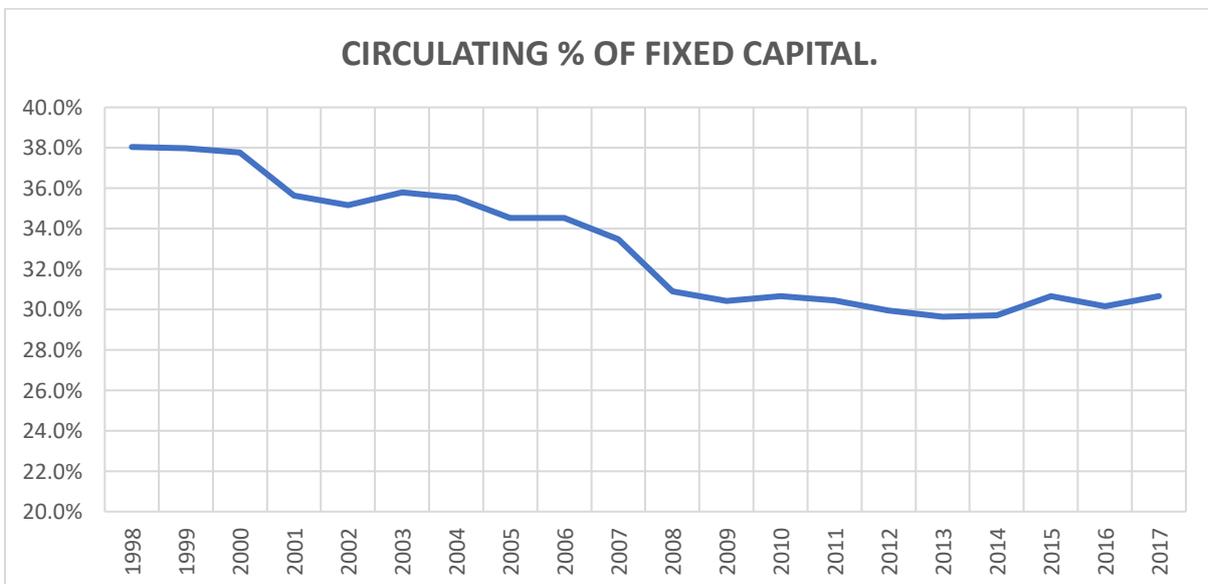
Graph 5.



The movement between the rate of profit and return varies from 2.5% in the trough of contraction to 4.5% at the peak of expansion. Measured quarterly the volatility would be even greater. The reason is that circulating capital accelerates in the pre-crisis period and decelerates sharply during the recession. In the former case it helps depress the rate of profit and in the latter case to raise it. Its movement is thus a key factor in the promotion of both crises and counter-crisis.

Now mark, the movement is greater than the 1.6% rise in mortgage rates that sunk the housing market. This is why it is methodologically unacceptable to omit circulating capital in determining the rate of profit and its movement. To highlight the role of circulating capital, Graph 6 plots its relative value compared to fixed capital and its movement over time.

Graph 6.



There are three important features to note. Firstly, as predicted by Marx's hypothesis relating to the composition of capital there has been a long-term fall in the share of circulating capital from 38% to

30% currently. All of this fall occurred pre-2008 due to much higher rates of investment in fixed capital during this time. Secondly, since the financial crash in 2008 the ratio has stabilised around the 30% mark. This is indicative of a deceleration in the rate of fixed investment. In other words, capitalism in the post-2008 period has been “sweating” its fixed capital base.

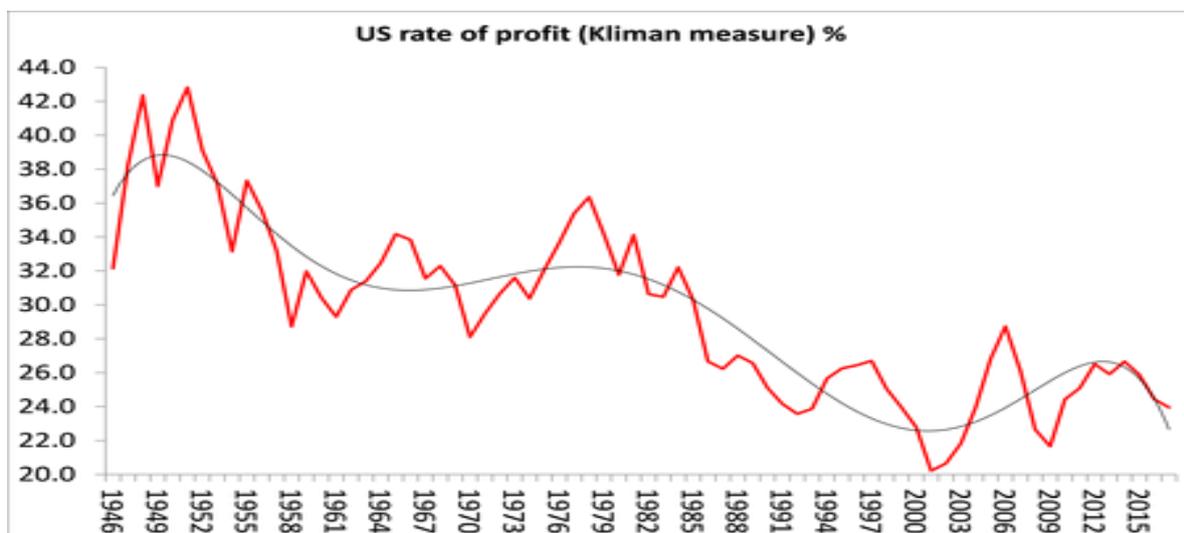
Thirdly, there has been a gentle increase in the amount of circulating capital over the last few years. This could be indicative of the rise in information technology. Much of these immaterial purchases appears as an increase in services which forms part of circulating capital. This is an emerging trend to which our attention should be riveted to. Whereas an increase in material inputs is normally associated with an increase in the volume of production, an increase in immaterial inputs could be associated with fall in the value of output. A rise in the value of inputs as against a fall in the value of output could have dramatic consequences for the rate of profit. It may already provide a part explanation as to why the rate of profit is so depressed in manufacturing. (Another reason is China’s move up the value chain.)

More analysis on this phenomenon is now possible following the release on 1st November of the *GDP-by-industry* 2017 data, particularly the *KLEMS* data. This will provide the focus for my next posting.

Michael Roberts report on the rate of profit.

In his posting <https://wordpress.com/read/feeds/313842/posts/2053027673> the first rate of profit that Michael presents is the one produced by Kliman, with which he concurs.

Graph 7.

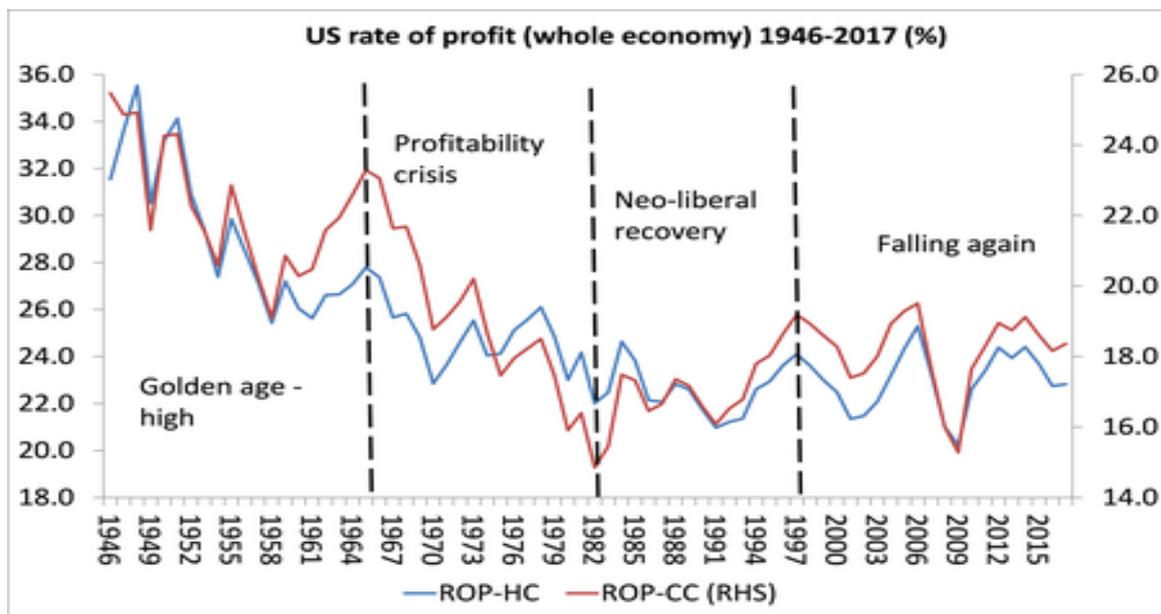


The first thing to note, is this rate applies to the corporate sector, where the rate of profit is in the region of 25% currently. This is double the rate of profit found in Graph 3. How do we account for this difference? Firstly, as Michael said, he uses historical cost to determine the value of fixed capital (adjusted for net investment inflation). This is profoundly wrong. The only way to measure the cost of fixed capital is to use replacement cost. As I show in my critique of Kliman’s book, “replacement cost” is an actual misnomer. It actually means the market value of the fixed means of production. (<https://theplanningmotivedotcom.files.wordpress.com/2018/07/kliman-review-of-the-failure-of-capitalist-production.pdf>) The actual replacement cost is actually much higher than the figures provided by the BEA. In any case, as circulating capital is measured at market value, so too must fixed capital. Secondly, it omits inventories. Thirdly, it omits variable capital.

Of course, the capitalist class would be overjoyed by a rate of profit double the actual rate, especially so close to Xmas. But from the standpoint of a Marxist, Kliman's methodology is misleading. Even in 2001, the low point, the rate of profit of over 20% was well above the 15% normally associated with the investment threshold, something Michael has spoken of so many times before. It follows that this rate of profit always guarantees a positive surplus on the cost of capital, so why would the capitalists go on an investment strike. Unlike Gordon Brown, Kliman has actually solved the boom bust cycle.

In the paragraphs below, Michael sets out his own methodology for the rate of profit. It is net surplus divided by productive capital plus annual compensation. He is correct to use the net surplus. Unfortunately, it cannot be used for the whole economy because of duplications (and not because of unproductive labour). For example, a chunk of the net surplus is made up of imputed rents, rents paid by owner occupiers to themselves as though they were their own landlord. This is equal to 8% of GDP (<https://www.bea.gov/research/papers/2017/imputing-rents-owner-occupied-housing-directly-modelling-their-distribution>) which Michael has included in his net surplus.

Graph 8.



Secondly, he uses annual wages as a surrogate for variable capital. They are not the same. Variable capital is annual compensation divided by the number of annual turnovers of circulating capital. Variable capital is thus much smaller than annual compensation which yields a higher rate of profit in turn. In manufacturing for example, annual compensation in 2017 was \$1,056 million while variable capital was only \$240 million, a difference of \$816 million or equal to the value of inventory. However, despite all these anomalies he too achieves a rate of profit 50% higher which never falls below 15% in all cases including 1982 and 2009.

It also has to be pointed out that the rate of profit in Graph 3 is much more volatile than the rates of profit in Graph 8. The relative fall in the rate of profit in Graph 3 from 2008 amounts to 36% while in Graph 8 it amounts to only 16%. Even allowing for visual inaccuracies, the relative volatility in Graph 3 is double that of Graph 8 which is more in accordance with the nature of capitalist cycles.

Moving on. In his discussion with Jonah and Murray he cannot be correct. Marx did not draw the distinction, which is so in vogue with contemporary Marxists, concerning productive and unproductive sectors. In fact, Marx said the opposite. Though he recognised the commercial sphere as being

unproductive, paid out of the price discounts provided by the industrial sphere, he still insisted that commercial profits had to be part of the equalisation of the rate of profit. It really is tedious having to repeat this. If commercial profits and possibly financial profits did not enter into the determination of the rate of profit, there is nothing to guide capital between these sectors. If the rate of profit was only known in industry, investors would not invest in commerce or finance lest they made a lesser profit.

What affects the determination of the rate of profit is not the distinction between productive and unproductive production, but the rather more mundane violation of Marx's stricture: "*thy shall not duplicate value*". What affects the rate of profit is missing intermediate sales, intermediate sales taken as final sales, final sales duplicated through imputations and the confusing of the mere exchange of money for the doubled sided exchange where value is both given and received. This is the distortion. That is why it is advisable to use only those sectors where these duplications are at a minimum. That includes but is not limited to manufacturing and goods production.

I will not comment on Lefteris Tsoulfidis' paper as I have not read it but will jump to Carchedi's methodology, However before I do I would like to point out that unless one can reduce annual compensation to variable capital, it is impossible to describe the composition of capital. The reason is simple. In the same year annual compensation can rise but variable capital can fall if the rate of turnover rises. Or, annual compensation can fall but variable capital can rise if turnover falls. Annual compensation cannot therefore act as a proxy for variable capital in calculating the composition of capital. Turnover is the gluon that holds everything together.

Carchedi prefers changes in new value (wages plus profits) as the short-term indicator. "*The crisis emerges when the fall in profitability causes a negative growth of new value. This is how falling profitability determines crises*". But as I pointed out to Michael in correspondence, not only is this tautological, it is the wrong way around. Falling profitability causes falling profitability because it depresses new value. Something is clearly missing.

What Carchedi is expressing is the **absolute** fall in the rate of profit. This fall is always preceded by the **relative** fall in the rate of profit, which is not necessarily associated with falling profits but with investments in capital outpacing increases in profit. This being so, in some parts of the economy, where the composition has risen fastest, it may no longer be profitable to invest. If this fall in investment is not compensated by rises in other parts, there is a relative deceleration in the general rate of investment. It grows more slowly or stagnates.

Consequently, demand falls. What was easy to sell is no longer easy. What took weeks now may take a month. What commanded full price now requires discount to entice sales. In sum a process develops whereby it takes longer to sell something and now always at a lower price. A realisation problem ensues. This is what Carchedi is referring to. Only now do we have the absolute fall in new value and with it for the first time, an absolute fall in the rate of profit. **Essentially, the crisis of realisation is a crisis of turnover.**

But all Carchedi is describing is the fact that when turnovers fall, so does the value realised in a given period. Hence what connects the relative fall in profitability caused by a rise in capital to an absolute fall in the rate of profit caused by a fall in profits, is turnover. Here is the missing link connecting investment with profitability. If Carchedi was weather forecasting, he would be forecasting yesterday's weather not tomorrow's weather. If one was to select the best leading indicator, one which is issued monthly, it would be the various sales to inventory ratios which mimics the turnover ratio.

They share the same rhythm because inventory is a major component of circulating capital. However, because the inventory/sales ratio is limited to the production period it does not cover the period of credit which completes the total circulating period. It is the combination of a slowing production period and an extending credit period, which in sum, is responsible for an elongation in the total circulating period, or, what is the same thing when measured annually, the rate of turnover. Because the inventory/sales ratio does not include the sales period, because it is partial, it generally underestimates the actual fall in the rate of turnover.

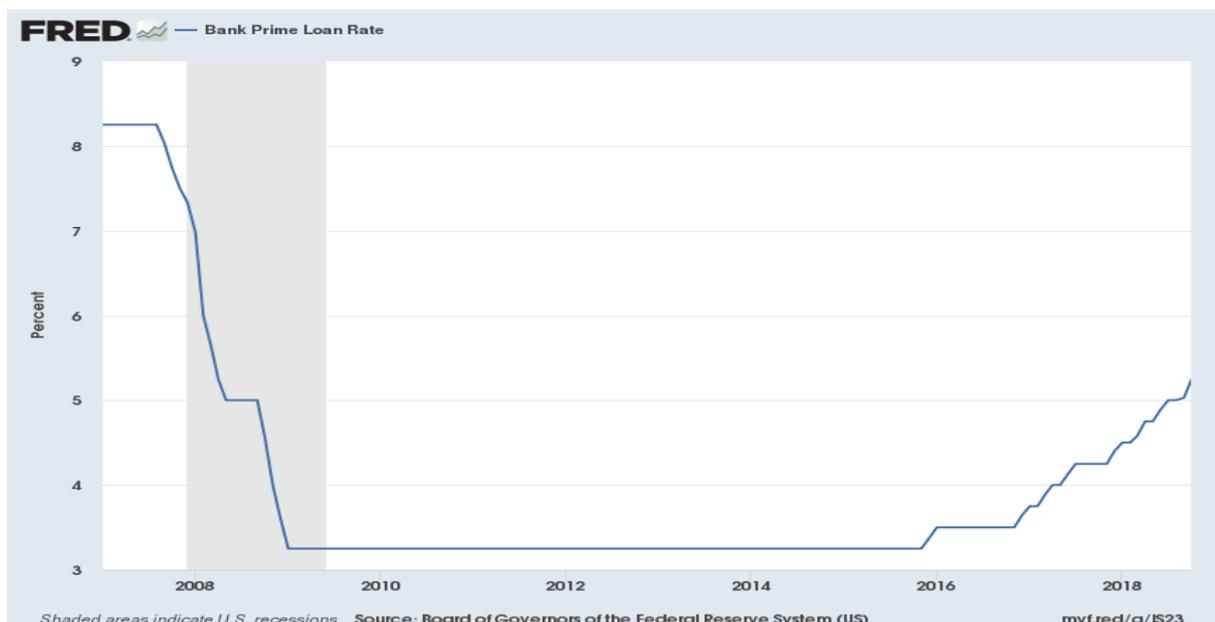
Despite my differences with Michael I stand shoulder to shoulder with him in recognising that it is profits that determine investment and not the other way around.

Conclusion.

Marx used the expression, “rising animation” to express a specific phase of the industrial (business) cycle. Its dominant feature is recovering profits and rising investment. However, because profits have only entered a recovery phase, that is they still stand significantly below their previous peak, much of this investment is funded through an increase in debt, borrowing. This compares to the next phase, that of “prosperity” where higher profits provide the bulk of investment (as pre-2014). I will provide greater detail when I examine corporate cash flow measured against corporate investment in the next posting.

Because the world economy remains trapped in rising animation, it depends heavily on the movement of interest rates. Though prime rates are below their recent 2007 peak, they are up 55% or 1.8% from the rates that prevailed from 2009 to 2016. As a result, October saw the first unsettling of the junk bond and highly leveraged bond market. Given the extent of corporate indebtedness, particularly in China and the US, the possibility of another financial crash looks increasingly likely.

Graph 9.



All it takes will be a perceived fall in future post tax profits. This event will crumble the asset bubbles exposing indebtedness, as it always does. The turbulence in the markets over October was the harbinger for this event, a reluctant admission that peak profits lie behind, not in front of investors.

Brian Green 3rd November 2018.