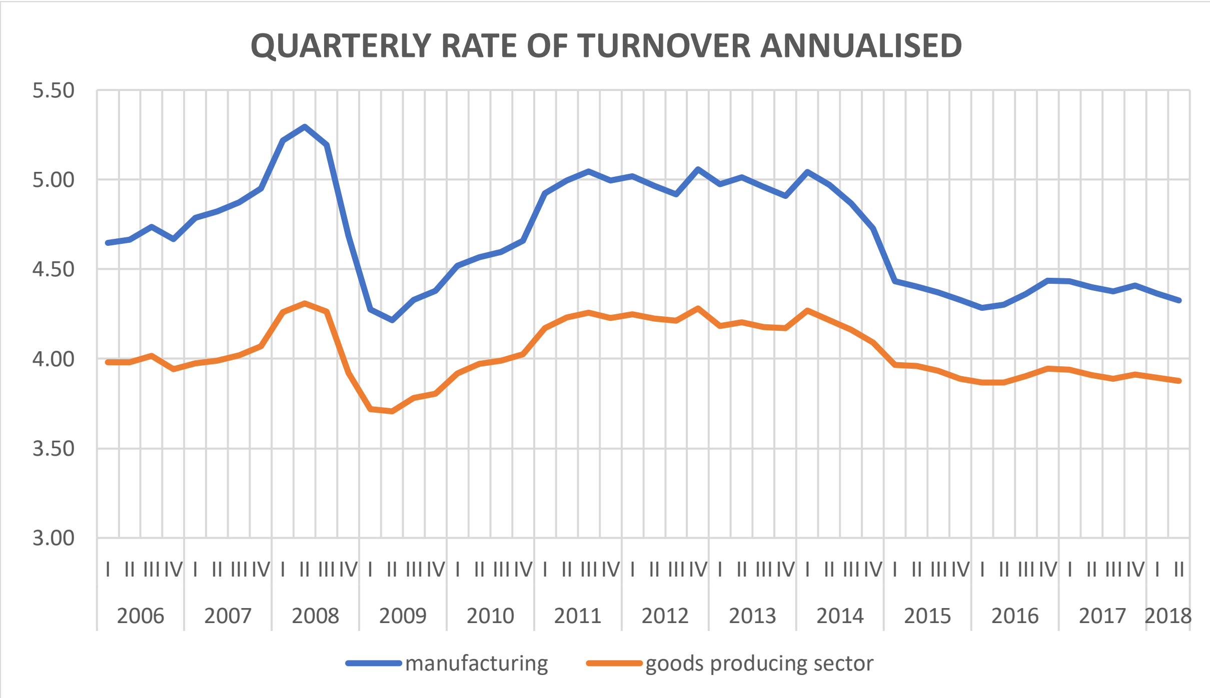
REPORT ON US ECONOMY.
Selling the highs replaces buying the dips.

It was fairly predictable that Xi and Trump would seek to defuse the trade war. Both of them possess glass jaws as the fragility of both economies and the world economy has shown. But this is a tactical pause, seeking to lift the markets and engineer a year end fillip to the market aimed at filling traders' Xmas stockings with bonuses and profits. However, when it becomes clear that the downward trend is established, trade war or no trade war, then the real war will break out.

This article includes a third quarter report on the state of the US economy. It has a slightly different format because there is more concentration on the non-financial corporate sector. The reason for this is that the data found in Tables 1.13 and 1.14 under GDP and Personal Income is more up to date than that found in the GDP-by-industry.

As usual the starting point is to examine turnover data for the manufacturing sector and the larger goods producing sector for Quarter 2. The results are presented in Graph 1 below. They show a marginal fall in turnover which of course is a negative indicator for future profits. Turnover, together with the rate of exploitation, is the bedrock of the economy. Together they make up the all-important rate of surplus value which alone determines the direction of profits.

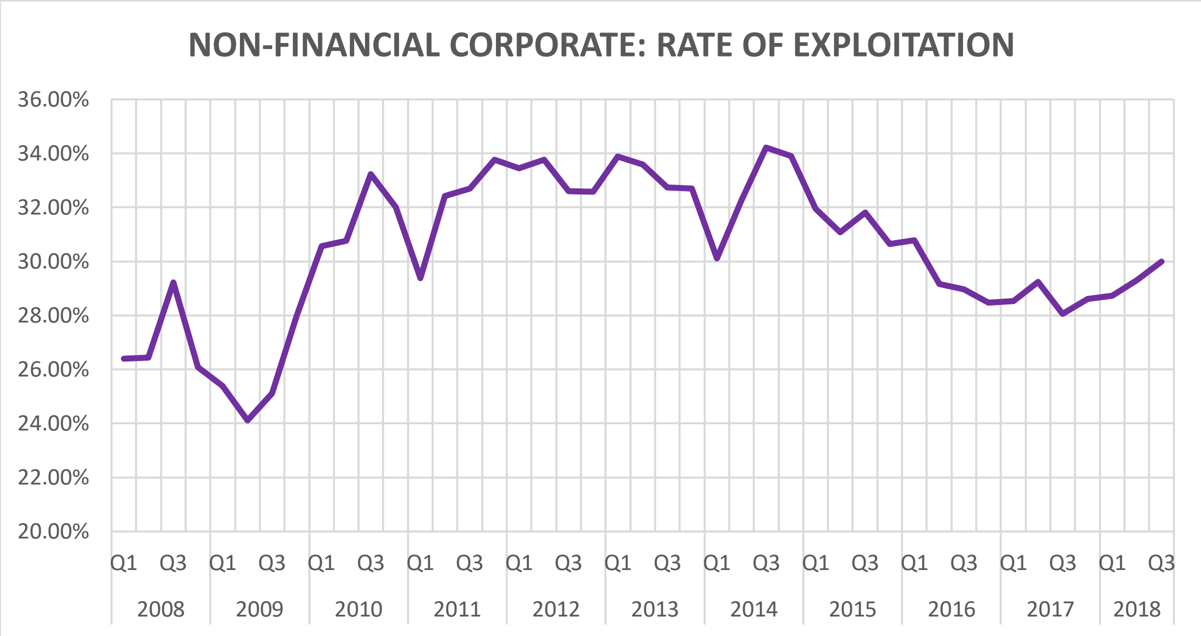
Graph 1.



(Source: Attached spreadsheet "G.O. UP TO Q2 2018")

Attention is now turned away from the rate of turnover to the rate of exploitation. Instead of manufacturing, the non-financial corporate sector is chosen, because provisional data is currently available for the third quarter of 2018. However, because the goods producing sector forms such a large part of the non-financial corporate sector in terms of revenue and profits, the turnover conditions found there are relevant to the corporate sector. Graph 1 shows that, given the deceleration in turnover, any improvement in profits depends on the rate of exploitation.

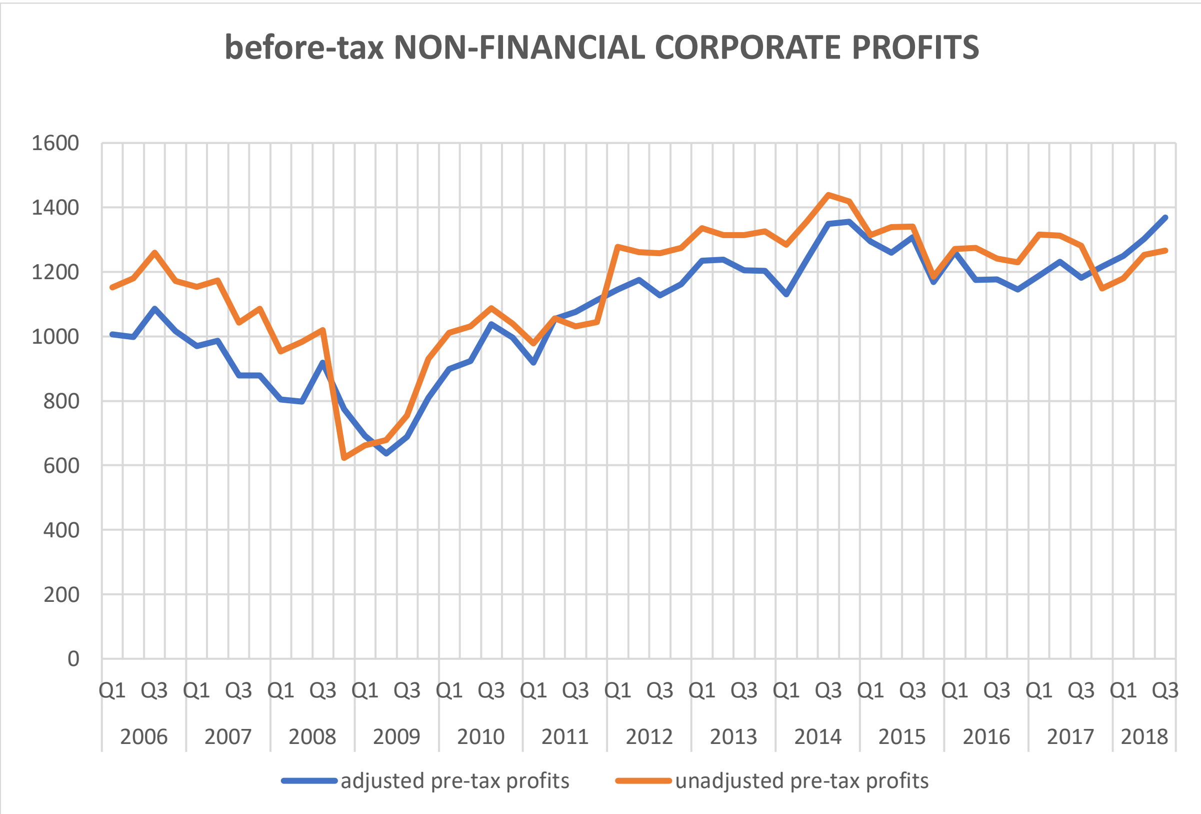
Graph 2.



(Source: Attached spreadsheet "TABLE 1.14 FROM 2006 TO Q3 2018")

There has been a significant improvement in the rate of exploitation since the third quarter 2017 amounting to 8% while turnover is down only 1% (Goods Producing Graph 1). The result has been an improvement in pre-tax non-financial corporate profits as shown in Graph 3.

Graph 3.

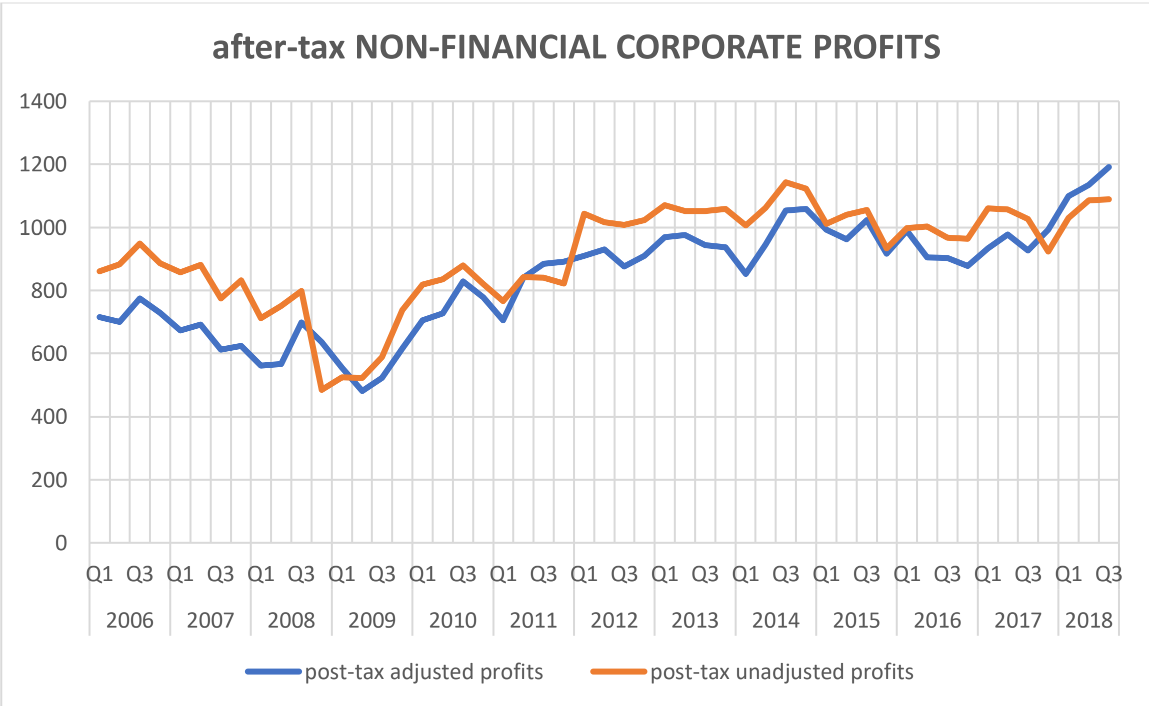


(Source: attached spreadsheet "TABLE 1.14 FROM 2006 TO Q3 2018")

This graph contains two series. The orange graph represents unadjusted profits (line 32 in Table 1.14) while the blue graph represents profits adjusted for inventories and capital consumption (line 11). The important graph is the unadjusted graph because it is the one tied most closely to the movement of net value added. Generally, we expect the unadjusted figure to sit above the adjusted figure but since the end of 2017 their roles have been reversed. This is entirely due the positive adjustment of capital consumption. It is difficult to determine the exact methodology behind this adjustment, but it may involve future discounted cash flows which the BEA mistakenly includes in its calculation of this adjustment. In other words, capital consumption is not simply about the depreciation of a fixed asset based on its economic life, but in order to smooth revaluations to the cost of fixed assets, the BEA includes future expectations of cash flow as well.

As a result of these adjustments, nominal profits (blue line) have increased by an annual rate of 11% while unadjusted profits have fallen by 1%. The depressed nature of unadjusted profits is the clue why the Trump tax cuts were needed. A last throw of the dice for a White House now turned into another Trump casino. Graph 4 below shows the effect of the tax cuts on post-tax profits. Here both adjusted and unadjusted profits increase nominally. Adjusted nominal post-tax profits rise 28.5% and unadjusted rise by 6% at an annual rate.

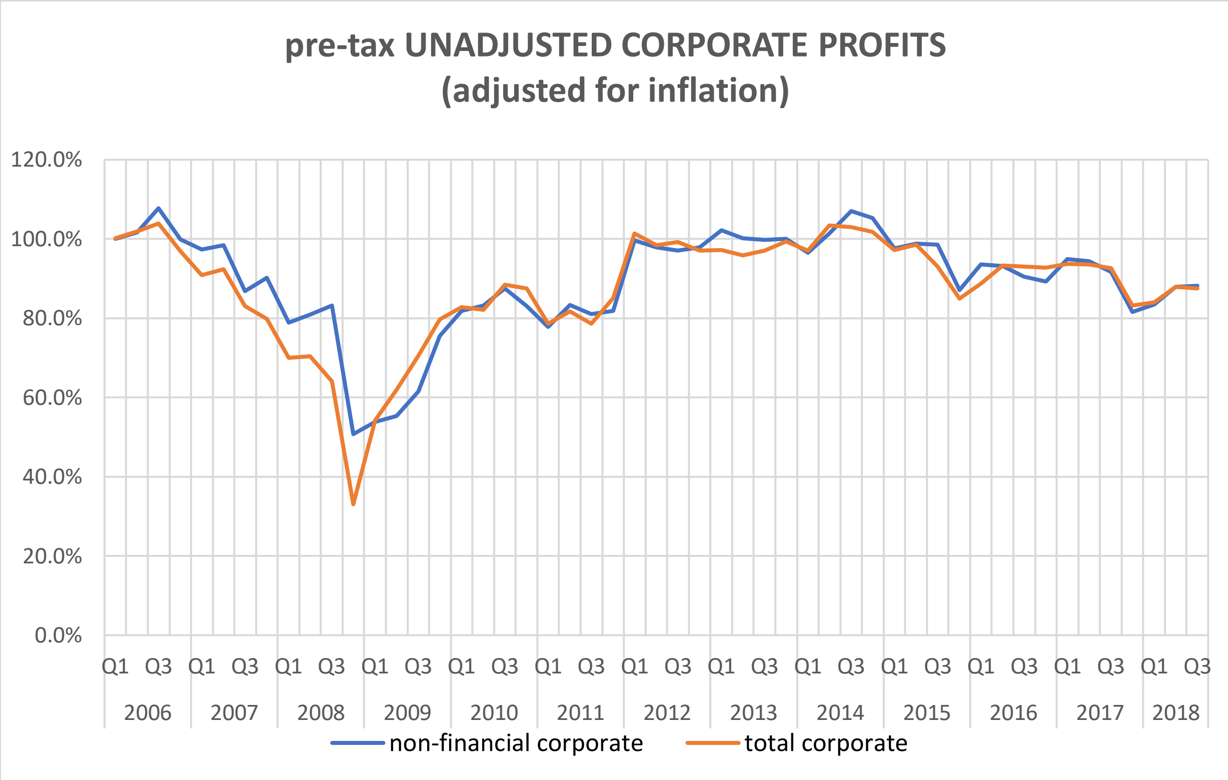
Graph 4.



Thus far we have considered nominal profits which ignore inflation. As inflation has been stronger this year it is a significant factor when determining real profits. This is done in Graph 5 below which plots unadjusted pre-tax profits for the whole of corporate and non-financial only. In order to show the movement relatively, this graph is indexed to 100% in the first quarter of 2006. Profits are converted from nominal to real by using the GDP deflator. As a result, two features stand out. Real unadjusted corporate profits in the quarter, despite the uptick, still stands 15% below their 2014 peak, with non-financial down 19%. Secondly, compared to the third quarter of 2017 the mass of profits is down 7.1%. It is clear profit growth has plateaued around 90% when set against 2006.

<u>This confirms the point I have been making repeatedly. As long as turnover is not accelerating, it is unlikely that profits will eclipse their 2014 peaks despite any improvements in the rate of exploitation.</u>

Graph 5.



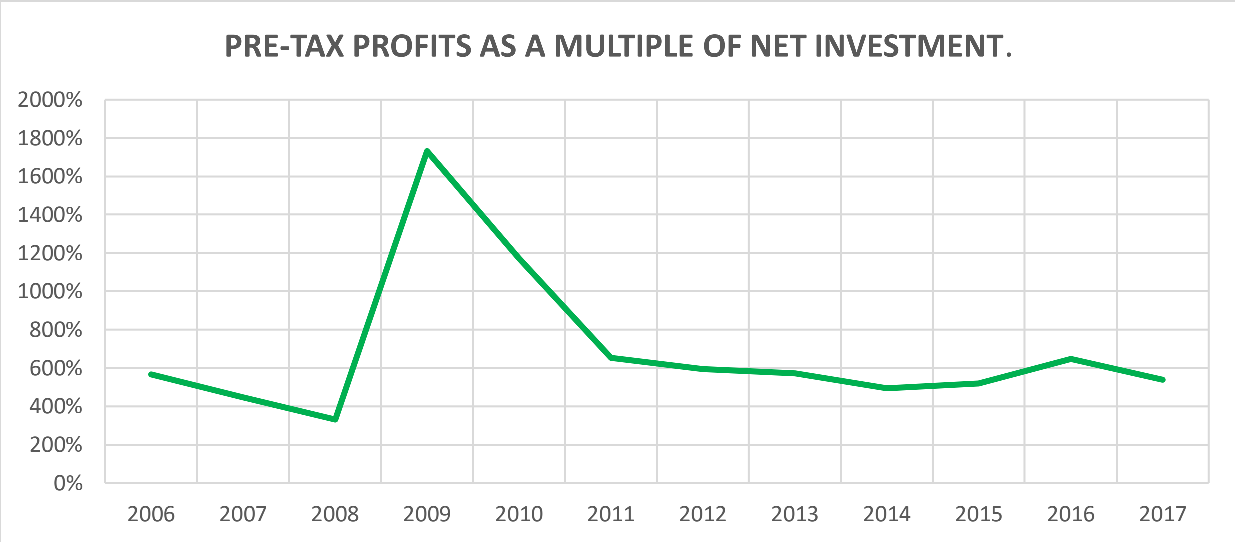
Besides greed, Graph 5 explains the need for corporate tax cuts despite the impact it has had on the fiscal situation and longer-term interest rates. However, like Apple and its raising of iPhone prices, this is a one card trick. However, unlike Apple it is the legacy of this one-card trick that will endure. This legacy will create a higher floor under interest rates as fiscal deficits exceed $1 trillion. This will "trump" any benefit these tax cuts have provided. Already, due to higher corporate indebtedness and higher borrowing costs, net interest is up in real terms by 16% compared to the third quarter of 2014.

Finally, on this section it is important to take a look at the relationship between investment and profits. Michael Roberts has provided substantial, and I may add incontrovertible evidence that it is profits that determine investment and not the other way around as the vulgar economists would have it. Capitalists invest to make profits and if they cannot make profits they stop investing. This is the ugly truth of capitalism. It is production for profit.

Graph 6 below is another way of looking at the connection. It shows that in downturns investment as a share of profits, collapses. And it does so despite the fact that the mass of profits has been reduced by the recession itself. If it was the other way around, then investment would increase because of the collapse of profits. Graph 5 above shows a 70% fall in real profits by the fourth quarter of 2008. It was still down 35% in 2009. And yet profits as a share of investment in this period trebled. This is nothing less than the law of the conservation of profits, or in in greater detail, capitalists slash investment during a profit crisis in order to conserve what remains of profits.

This graph selects net investment rather than gross investment. It arrives at net investment by deducting depreciation from gross fixed investment. While net investment is problematic because of inflated depreciation, comparing gross fixed investment to profits would be an error.

Graph 6.



(Sources: Table 1.14 for profit, Table 6.7 for gross fixed investment and Table 6.4 for depreciation.)

Financialization.

There are more fictions surrounding fictitious capital than there are forms of this this magical "capital". I refer to a recent debate on Michael Roberts' site aptly named *Financialisaton or Profitability.* **https://wordpress.com/read/feeds/313842/posts/2080839284**
To continue the debate on his site would be to abuse his hospitality. But it is a debate which must continue because we are on the edge of another economic crisis, and as always, the symptom will be confused for the cause.

The October and November gyrations on the stock exchange had one major and one minor cause. The first was the recognition that peak profits had been reached and that the future outlook for profits was receding. Hence it was a case of cashing in paper profits particularly FAANG shares which are a busted flush in any case. The 20% fall in share prices by the likes of Amazon, Facebook and Apple in October and November effectively cost investors more than the entire benefit they received from Trump's tax cuts. Should profits deteriorate, then nothing Trump does pragmatically on the trade front, will arrest the fall in the economy. This was demonstrated on Tuesday 4th December.

The second minor cause is the issue of interest rates. The FED's tightening of the money supply and higher borrowing needs raised the 10-year yield to 3.26% and the Prime Loan Rate to 5.25%. This had an adverse impact on share prices. However, the darkening outlook since October has seen interest rates reverse, with the 10-year yield falling below 3.0% and the Prime Loan Rate falling back to 5.03%.

Interest rates will be discussed more fully in the next section. The point here is to examine the link between the flow of surplus value and the claims on it. Marx made a distinction between actual industrial capital and commercial capital, and, the "paper" giving title to those real assets. This "paper" has to take specific forms. In so far as it gives title to a stream or profits it is called a share, in so far as it gives title to a stream of interest it is called a loan, and in so far as it gives title to a stream of rent it is called a mortgage or deed.

This paper has economic value only because it represents a definite and legal claim to future income from labour (surplus value) backed up by the state. Otherwise it would not be worth the paper it is written on or the electronic entry formed in some computer. If we lived in a static world where income was fixed then the paper which gives entitlement to it would not be volatile, and, in the presence of predictability, there would be no secondary market for this paper.

But capitalism is volatile making the income stream unpredictable, and the balances between these streams unstable. This then forms the playground for speculation. At this point we must stop. There are two forms of speculation. The first is what Marx concentrated on in Volume 3 and that is the speculation that flows from the time lag between sale and payment. This lag which is made possible by credit allows the buyer to speculate on the movement in prices between the point of sale and the point of payment which may be delayed by more than three months. (In Marx's day this form of speculation was prevalent in international trade because of the more primitive technical conditions found in this sphere.)

This element of speculation is ignored here. Instead we will focus on the second and larger form of speculation, the speculation on the entitlement to income. While this form of speculation has nothing to do with bills of exchange, a credit-crises in the sphere of goods normally precedes a crisis in the sphere of titles to assets. In some cases, it can act as a trigger for a broader financial crisis.

Turning to the sphere of titles, the first point to make is that the price of these titles exceeds the annual income on which they are based. This seems to be such a mundane point because it is taken for granted and rarely questioned. However, it does lead to much confusion. If we take the price of a share, it may be worth 15 times the annual profits it can claim. So far so good. Let us put numbers to it. If the annual profit is $1 trillion, then the shares will be worth $15 trillion. A sizeable amount. If the ratio remains the same, such that $15 dollars is needed to access $1 of income, and profits go up the following year from $1.0 trillion to $1.1 trillion, then everything else being equal, the price of the shares goes up to $16.5 trillion.

This represents an increase in share prices of $1.5 trillion. Even if no share changes hands, shareholders are collectively $1.5 trillion richer because workers have increased profits by $0.1 trillion. From the point of the individual shareholder their annual return has not changed, it is still 1/15th of the amount needed to join the class of exploiters.

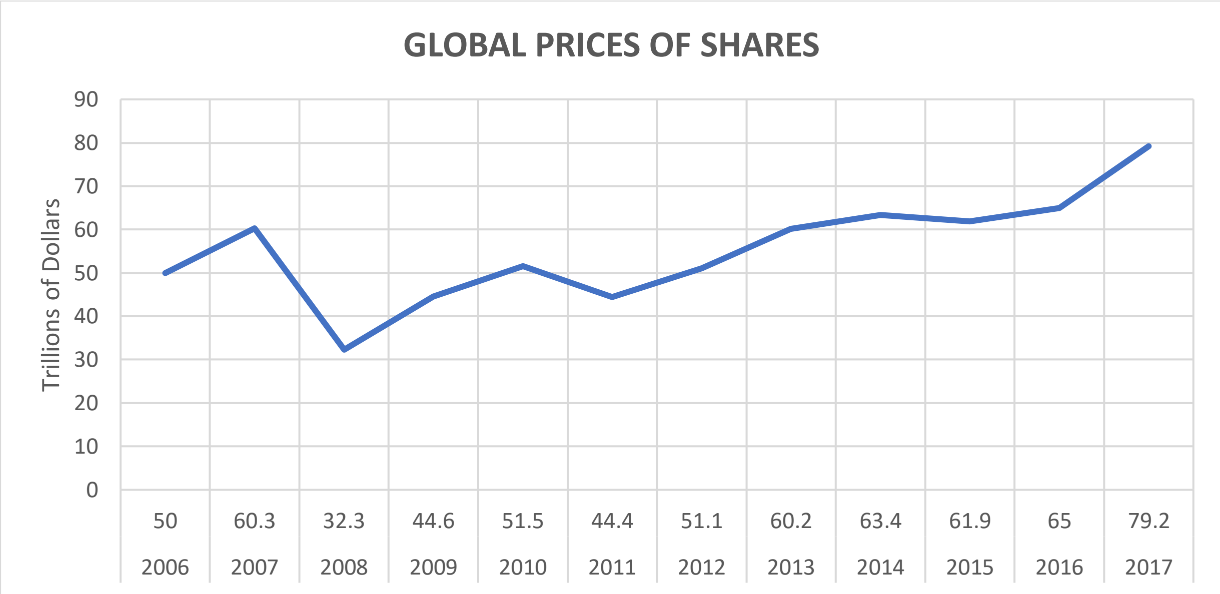
Of course, in the real world there is a market for these shares. If 50% of shares change hands that year, an additional $0.75 trillion is needed to circulate these shares. This circulation is generally but not exclusively made possible by the banking system which centralises individual hoards of money, such as the gains made by the sellers of these shares, as well as additional credit which the banks are proficient at generating. Because the cost of joining the exploiting class goes up as profits rise and with it share prices, many myths have grown up. But the fact that the price of shares or any of the titles are multiples of the income they attract has always been at the heart of capitalism.

If the multiple was only 1 which means that the price of a share was equal to the annual income, in this case the price of shares would be $1.1 trillion and annual income also $1.1 trillion, well then anyone could join the exploiting class. Share prices have become a multiple because of credit, credit only available to the few with collateral. The multiple has been set by the balance between the return and the cost of borrowing and expectations on both sides. As long as the return is higher, and stays higher, the credit is secure. If it falls below the cost of borrowing, well then it is better to use one's money to lend rather than borrow. Once again it is a matter of demand and supply, though to be candid, supply is very stretchable especially during a speculative fever.

The essential point is this. Multiples are not infinitely elastic. They change according to the phase of the industrial cycle and nothing else. In the phase of stagnation, multiples are low as profit expectations are subdued. In the phase of rising animation, multiples begin to rise as profits begin to recover. Multiples accelerate in the phase of prosperity as profits grow faster eclipsing previous peaks. In the short feverish phase, they become stupid. They then collapse in the financial emergency (Marx), or what we now call the crash, as overextended and over-leveraged investors are forced to sell their holdings at any price.

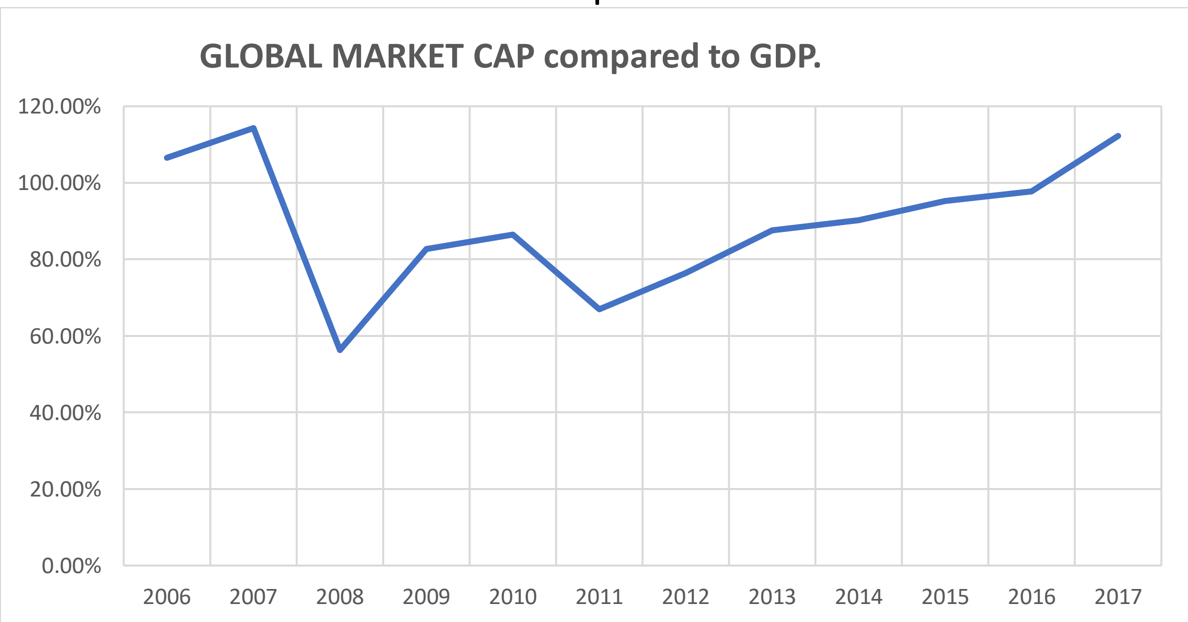
Turning to the real world, the aggregate price of all shares traded on all the world's stock exchange is listed in Graph 7. The data belongs to the World Bank and can be retrieved on the following link, https://data.worldbank.org/indicator/CM.MKT.LCAP.CD

Graph 7.



This is what the total cost of joining the club accessing the global pool of unpaid labour amounts to. It also shows how volatile the cost is due to the oscillation in profits. Between 2007 and 2008 nearly $30 trillion was lost in the financial crash. The scale of this loss is best seen in the next graph.

Graph 8.



(Source: https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS?end=2017&start=1975&view=chart)

We note that the fall in share prices in 2008 was equal to 50% of global GDP. A huge amount. It is the sheer scale of this volatility that has given succour to those who believe that stock markets and titles in general have broken free and have risen to heavenly independence. Nothing could be further from the truth. Over the last thirty years, stock prices adjusted, not against GDP, but against the share of profits in GDP, have been remarkably consistent. True over the period of globalisation the new plateau they occupy is higher than before, but that plateau has not given way to an even higher plateau since the late 1980s. But the point is, averaged out, it costs the same number of Dollars to gain access to $1 dollar of profit today as it did in the 1990s.

Titles which give direct access to either profits, interest or rent, can be described as Tier 1 or "Primary Fictitious Capital". To recapitulate, they comprise shares, bonds, government bonds which access taxes (or gilts in the UK as they are called) mortgages and deeds. They access a finite pool of surplus value generated by productive workers in the process of producing commodities. The movement of these shares is ultimately regulated by the movement in realised surplus value, though it is influenced additionally by the movement of interest rates.

There is another tier of fictitious capital, Tier 2, "Secondary Fictitious Capital". It is distinguished from primary paper because it has no direct claim on the finite pool of unpaid labour. These titles include options, futures, swaps, puts and so on. The capitalist class has no problem understanding that derivatives are not a direct claim on income. "*A derivative is a financial security with a value that is reliant upon, or derived from,* ***an underlying asset or group of assets.***" Well said, my emphasis. https://www.investopedia.com/terms/d/derivative.asp#ixzz5YdiLNZlx

It seems that the only people who do not understand this distinction are a group of Marxists who are criticising something they do not understand, which always amounts to bad practise. Secondary fictitious capital is in effect a bet on a bet. It is a bet on the movement of the underlying asset, on whether it is going up or going down. This can apply to bonds, shares, currencies, metals, pork bellies and so on.

This betting is not benign. What it does is to stretch the valuations or alternatively compress the valuations of the assets on which it rests. For example, a "future" is generally a bet on the movement of share prices in the future. If the view is that share prices are going up, then a future is bought. Generally, futures are bought on a margin, say 10%, meaning any profits are multiplied 10-fold.

The opposite happens when a future is sold in advance. Now profits are made if the price of a share falls. Once again the profit is multiplied by the leverage. Of course, investors may place a bet in the wrong direction. When this happens, instead of making a 10-fold profit, they end up making a 10-fold loss. One does not have to understand the mechanics to understand the result. Tier 2 speculation pushes up prices of the assets it is betting against more than would the case be were the market left to Tier 1 investors. Conversely if futures are sold, it drives down the prices of assets more than can be expected from the normal operation of Tier 1 investors.

This has consequences for Tier 1 investors. When valuations are stretched upwards by Tier 2 speculation it costs more to join the club of exploiters. For example, if the activity of secondary speculation raises the price to earning ratio of shares from the 15 we have discussed, to 20, then the annual return falls from 6.7% to only 5%. It now costs $20 to earn $1 dollar of annual income compared to $15 dollars before. Put another way, it originally took 15 years to recoup one's investment, now 20 years.

This represents a loss to Tier 1 investors. Yes, it does, despite the capital gains (paper gains) made by the existing holders of shares. Only they make any capital gains. New entrants do not. They have to pay a premium to gain access to the unpaid pool of labour. What took $15 now costs $20.

In other words, all that Tier 2 speculation achieves is to drive up the cost of gaining access to the pool of unpaid labour. It does not and cannot affect the pool of unpaid labour derived from the production and sale of commodities. The capital gains made by Tier 2 speculators derives purely from the movement of the underlying assets, which in turn are responsive to changes to the realised pool of surplus value.

Speculation can be compared to an inverted giant pyramid, comprising layers of leveraged bets, resting on a tip supported by a pedestal built out of surplus value. Over time, relative to the pedestal, the pyramid grows larger and potentially more unstable. Any changes to the pedestal due to the movement of the industrial cycle, undermines it. When this happens, it topples over. This threatens not only investors, but workers unless they protect themselves. This is what happened in 2008 when workers were forced to repay the speculators via the state.

In 2008 the construction industry was only 8% of world GDP, but mortgages was it's the single biggest financial asset because the duration of mortgages are typically 25 to 30 years. Sitting like a "Giant Squid" on this pile of mortgages were the secondary market speculators. The dicing and splicing of these mortgages, together with the associated hedging, was sufficient to paralyse the entire world financial system when everything came crashing down.

In summation, secondary betting is not a free lunch. Sure, the leverage employed here results in eye watering gains if the bet is in the right direction, just as it leads to drenchy-sweaty losses when the bet is in the wrong direction. But all these gains come at the expense of Tier 1 investors who have to part with more money should they wish to expand their portfolio.

This is what has transpired in the last thirty years as banks have discovered the dark arts of derivative speculation, some of which are so complex they cannot be understood by investors. But in an era of greed, ignorance is a disconnected brake. It is this secondary speculation that helps explain why yield hungry investors like pension funds are out of pocket. Whatever the ignoramuses say, capital gains are no substitute for healthy returns in the long run.

Current perspective.

The world economy is teasing the capitalist class. No sooner did the prospect of a synchronised acceleration of the world economy materialise then it all fell apart. The fact is that since the end of 2014, the capitalist system has been living from hand to mouth. In early 2016 the FED and the PBOC had to step back from financial tightening, doing a 2005 in order to reflate the world economy. A year later in the lead up to the 19th Congress in China the Chinese economy was stimulated to prevent spoiling the party at which Xi was to be anointed Emperor. When this stimulus faded, along came Trump and those "fiscal disciplinarians", the Republican Party with their tax cuts.

The fact is that these interventions only postpone the inevitable and make the outcomes worse. Booms and busts form a necessary capitalist unity of opposites. Without busts there cannot be booms and without booms there would be no busts. The difference between the two consists of only this, the booms in so far as they expand production exceed the busts which contract production. This is the convulsive movement of this primitive industrial society. If booms did not exceed busts, there would be no economic development robbing capitalism of any dynamism.

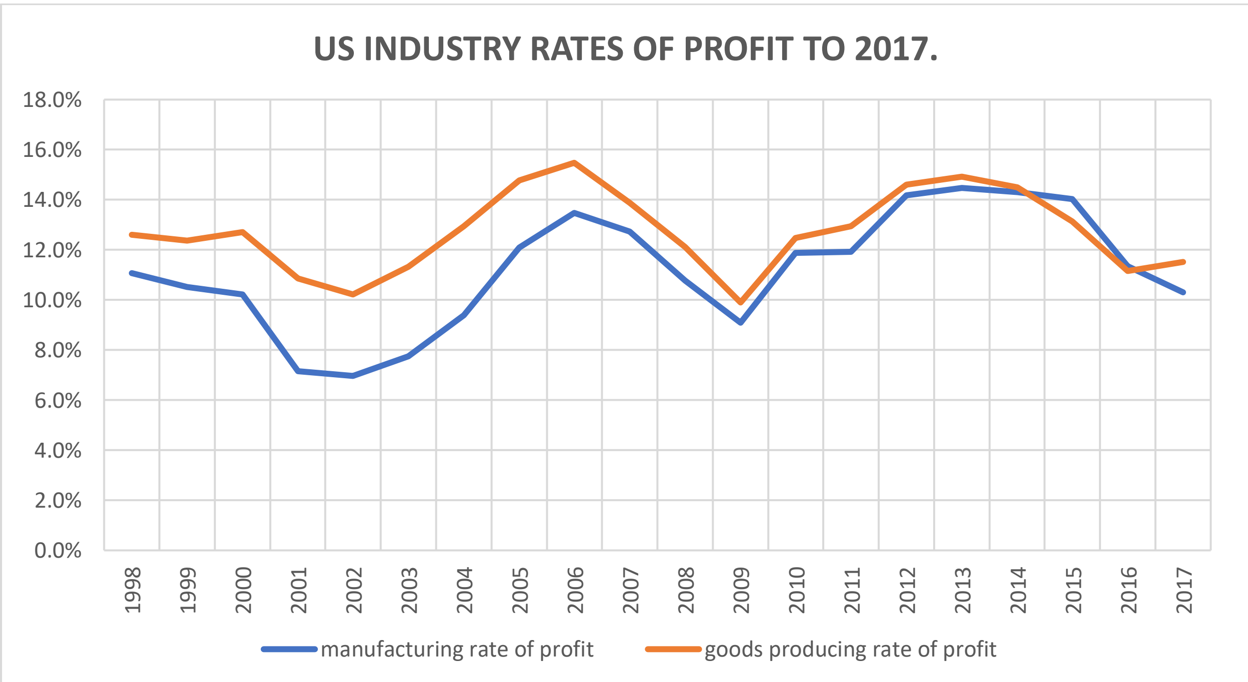
Capitalism cannot help itself over-producing commodities nor over-accumulating capital. This over-production and over-accumulation is not measured by the needs of society, but more narrowly by the needs of profitability. The boom ends when production yields a lower rate of profit, or more accurately when the rate of profit falls absolutely. Each new investment now yields less profit. As the capitalists are only interested in making more money not losing money, they conserve their capital instead of investing it and production comes to a standstill. At that point the whole financial edifice crumbles revealing their structures to have no more substance than the props in a movie set.

The last business cycle dated from 2008 to 2015. However, a full-blown recession was avoided by the actions of the FED and the PBOC. The result was that the excesses were not purged from the system. Instead debt continued to pile up while profits remain trapped at levels below their 2014 peak (or 2012 in China). There is a dominant view that the world economy is approaching the end of the current business cycle because it is erroneously date it back to 2008. It is worse. We are actually in a new cycle which has been aborted precipitating additional consequences for the world economy. The old has not been purged and the new has been added to it. I have described this as a world economy trapped in the phase of rising animation, like a car with its driving wheels spinning deeper into muddy debt while the rubber slowly burns off the rim.

The rate of profit in the US has always been a marker for profitability in the global market. The reason for this is that the US still monopolises most of the sectors that make up global production. With the exception of autos and heavy industry, all the major industries continue to be headed by US multi-nationals. This is exemplified by Apple whose profits in the final quarter of 2017 was still 87% of the global smartphone market, though this had fallen to under 70% by mid-year.

If the US still continues to monopolise the heights of the international value chain, despite losing some of its grip, then the fall in the mass of profits since 2014 must be representative of the world economy at large. As many of the US multi-nationals are located in the manufacturing industry, the most recent rate of profit is revealing. It has fallen from 14.9% to only 10.3% in 2017 barely above the rate that obtained in 2009. (s/(fc + cc) where s =surplus value, fc = fixed capital, cc = circulating capital)

Graph 9.



Currently, the outlook for profits has dimmed in the rest of the world as well. This is true for China, Japan, South Korea and Germany. In China, October's annual profit growth of 3.6%, was barely above the rate of inflation, and compares to the 17.2% growth in the first half of the year. Interestingly, the rate of turnover for Chinese Manufacturing slipped as well. China provides data for the "inventory turnover of completed goods" and the "days of sales outstanding", allowing for a back of the envelope calculation of turnover rates. As late as 2016 China enjoyed a rate of turnover of over 6. Now that has been reduced to just 5.4 [365/(18.6 + 49.4)]. This is a similar relative fall to that found in US manufacturing. (www.stats.gov.cn/enGliSH/PressRelease/201811/t20181128_1636431.html)

The world economy is at a tipping point. The two thousand corporations that dominate the world economy require a single world market to free their potential. Instead they are being suffocated by protectionism. The capitalist world has been Brexited.

This is the significance of yesterday's 3% fall in US stock markets despite the FED softening its tone on tightening and Trump in his usual ebullient manner, overpainting what was achieved at the G20 trade talks. What spooked the markets, putting it on suicide watch, was the inversions in the bond markets. The collapse in long end yields, particularly the 10-year yield, which sent them colliding into shorter term yields such as 2-year yields, was an indicator of darker times ahead.

Previously the markets had been pricing in higher inflation and higher yields as the economy began to "overheat" in the late stage cycle. What the collapse in longer yields indicated was a collapse in inflation expectations as raw material prices, particularly oil, collapsed and that far from over-heating, the economy was coming off the boil.

This is confirmation of the thesis that we are not in the late stage cycle but in something worse, an indebted economy that is allergic to higher interest rates. This was confirmed by the concurrent announcement by Toll Brothers, one of the largest housebuilders, that their house sales in California had fallen by 39%, together with the previous announcements by Ford and General Motors that they were radically restructuring their businesses. The capitalists' confidence in the future is deeply undermined.

At the *Historical Materialism Conference* a few weeks ago two themes were present. Firstly, there was no anticipation of another crash. Secondly, there was no conception of the extent to which the political structures of capitalist society will be shaken by the crash. The pre-occupation was with the rise of the right. But the right can still be compared to a sparkler which burns bright, furiously and quickly.

We need only look at Trump lashing out at General Motors to realise he understands his vulnerability. It is likely that once Balsanaro attacks his base in Brazil, as his neo-liberal economics dictate, his fall in popularity will be as quick as that of Macron in France and be greeted by similar unrest. The same applies to Italy, particularly as the EU heads into recession forcing the alliance to continue the policy of austerity.

Of course, the cake goes to Britain and its Brexit negotiations. As the MPs hammer it out, they do not notice the sky darkening outside the hallowed halls of Westminster. Like a skier intoxicated with fumes of past greatness, with one ski facing forward and the other backward, they do not notice the avalanche that is the world economy developing up the ridge. Those who "voted to take control" are about to find out what happens when a world recession takes control of an economy already weakened by frustrated negotiations.

What is coming cannot be compared to 2008. It is structurally deeper and focused in production rather than in residential property. At the same time the resilience of the world economy is lower than it was in 2008. Finally, the counter-vailing factors are weaker. The ammunition lying in the vaults of the central banks is depleted. China is in no position to replicate the massive wave of fixed investment that re-floated the world economy after 2009.

The only saving grace, as far as the capitalist class is concerned, is the passivity of workers. But this can and will change with another economic crisis, and it will change abruptly. Workers allowed the capitalists to get away with it once in 2008, they will not give them a second chance, especially after all the sacrifices they have endured these long hard ten years. Even without another recession, austerity has ensured that longevity has fallen on average in the 18 richest capitalist economies (https://www.bmj.com/content/bmj/suppl/2018/08/15/bmj.k3096.DC1/mid_life_mortality_v37_datasupp.pdf). In the USA longevity has fallen three years in a row. The last time this happened was World War 1 and Spanish Flu, 1917, the year of revolution.

Above all, another crisis will permanently end the legitimacy of capitalism, just as it will demoralise the capitalists themselves. These changed material conditions will form the platform for the ideological struggle where we need to excel. We are obliged to demonstrate a deep understanding of how capitalism works and how it fails, together with a programme that clearly demonstrates a future alternative to the current ruinous mode of production.