CENTRAL BANKERS BOTTLE IT.

> *This week the "central committees" of the Federal Reserve and the Bank of England met. Neither Bank dared raise interest rates. Translating banker speak about "substantial economic progress" translates into a lack of confidence that the economy and especially the markets could weather a rate rise.*

First the Bank of England report is linked below. It revealed that the BOE decided to hold interest rates at 0.1%, the lowest for over three hundred years, by a margin of 7-2 and to continue with a further £20 billion in QE by a margin of 6-3. The report indicated that interest rates could rise to 1% by the end of 2020. Unlike the FED statement the BOE acknowledged that recent growth both in the UK and globally was disappointing. With regard to inflation the BOE expects it to peak at 5% around April before falling back materially in the second half. https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2021/november-2021

It is worth pointing out that Bailey was chastised for implying that a rate rise was imminent before the meeting. This is what Andrew Sentance a former BOE committee member tweeted. "*More misleading signals from the #MPC. These days, they always delay or duck the challenge of raising rates. A shambles from a so-called independent central bank."* The failure to raise interest rates when the expectation was put at a 60% certainty rumbled the markets with Sterling falling by 2 cents against the Dollar and Building Societies dusting off mortgage offers they had pulled in expectations of a rate rise to 0.25%.

On the other hand Powell was more upbeat in his meeting with the press following the gathering of the Open Market Committee. "*With COVID case counts receding further and progress on vaccinations, economic growth should pick up this quarter, resulting in strong growth for the year as a whole." We don't see troubling increases in wages, and we don't expect those to emerge. We don't think it's time yet to raise interest rates. There is still ground to cover to reach maximum employment both in terms of employment and terms of participation."* On the issue of inflation, he appeared to be unconcerned: "*Our tools cannot ease supply constraints. Like most forecasters, we continue to believe that our dynamic economy will adjust to the supply and demand imbalances, and that as it does, inflation will decline to levels much closer to our 2 percent longer-run goal*." On the issue of interest rates he stated the FED did not believe it was time to raise them. So inflation, employment and wage rises were not anything for the FED to be concerned about because they were fleeting, for it can only be that way in a 'dynamic' economy. *https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20211103.pdf*

What the FED did agree to confirm was tapering. "*In light of the substantial further progress the economy has made toward the Committee's goals since last December, the Committee decided to begin reducing the monthly pace of its net asset purchases by $10 billion for Treasury securities and $5 billion for agency mortgage-backed securities. Beginning later this month, the Committee will increase its holdings of Treasury securities by at least $70 billion per month and of agency mortgage-backed securities by at least $35 billion per month."* Thus by May next year QE will be QED.

JP Morgan commented after this Press Briefing that they did not foresee a rate hike at all before the end of 2022. *"I don't expect a rate hike in July or in September, what I think they're trying to do is draw space between when they're done with tapering (and) when they start tightening because they've always tried to say these are two distinct things," said David Kelly, chief global strategist of J.P. Morgan Asset Management.*

I hate to agree with Central Bankers, but I too believe that inflation is transitory. Moreover, when the wave of investment is considered, the medium-term outlook is not one of inflation, but deflation caused by over-investment. Today the new oil, is computer chips. It plays the same role in terms of magnitude as oil did in the 1970s. Given China's plans to duplicate FAB production to make it relatively independent of foreign producers especially TSMC, the vista of an epic oversupply of chips is emerging. Already demand is fraying as it falters because Covid support funds have been spent and personal saving rates have normalised. Here is a recent report. "*Mercury Research (via PCMag) said the PC industry just experienced its biggest quarter-over-quarter decline in laptop CPU shipments. Shipments fell by more than 18 million units in the third quarter compared to the previous quarter, the PC component market research firm said*." https://www.techspot.com/community/topics/demand-for-low-end-laptop-cpus-plummets-and-not-because-of-the-chip-shortage.272067/ In addition the site reported a 6.7% fall in smartphones in the 3rd quarter year on year, but mainly lower end products. https://www.techspot.com/news/92041-global-pc-sales-fall-two-percent-year-year.html

The other reason why inflation is likely to subside and why we are past peak inflation, unless a new variant of the virus sickens society, is that M2 (money supply) has normalised. Once again unspent revenue, crystalised value from previous periods of production has reverted back to over 92% of the money supply, having fallen to below 80% during the pandemic when fiscal money rose from 3% to 15% due to a fall in production and the infusion of Covid Funds. Unspent revenue is invariant thus it acts as the ballast in the money supply keeping prices stable and the more M2 consists of revenue, the more stable prices become.

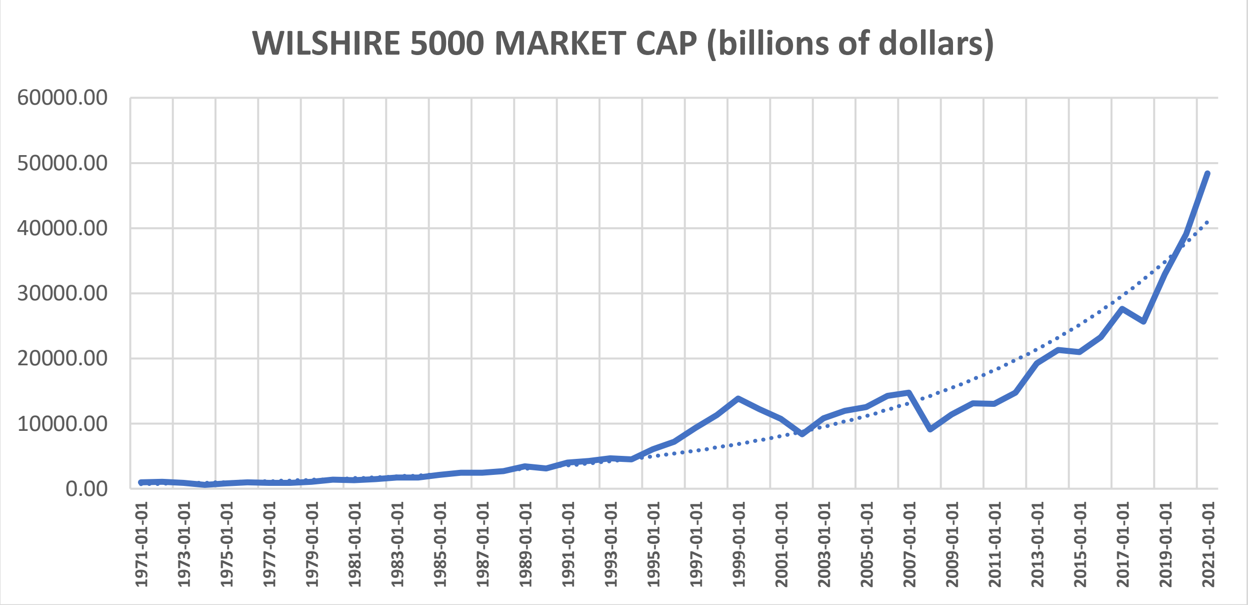
For the time being the balance in the labour market has shifted in favour of workers. But that will not endure for more than another 6 months. Workers need to take advantage of this window, rebuild their unions and strike where necessary. Should they do this then inflation may remain elevated for a longer period. This is the one incalculable factor. If they succeed then inflation may regain its status as the barometer of the class struggle once more, because if profits are legalised theft, then inflation is an act of fraud because workers are being paid with a debauched currency.

A financial bubble too big to fail.

Of all the measures I have investigated to determine whether or not a financial bubble exists, the one presented below and which I have used a number of times already is the most accurate. It contrasts the real multiple with the fictitious multiple. The real multiple uses as its numerator, fixed capital plus circulating capital while the fictitious multiple uses the market cap made up from 97% of listed shares as found in the Willshire 5000 index. They both use the same denominator, pre-tax unadjusted non-financial corporate profits. In other words, the real multiple is the inverted rate of profit, while the fictitious multiple is a modified version of the typical P/E ratio.

In a healthy economy the fictitious multiple should always sit below the real multiple. The reason being that not all profits can be paid out as dividends. A reserve needs to be held back for future investment, repayment of debt, contingencies etc and that is normally reflected in a dilution of the P/E ratio locating it below the real multiple. This used to happen but not when the Willshire 5000 does this. Between 2009 and the present, the index has grown nearly 5-fold, powered by rocket fuel prepared by central banks.

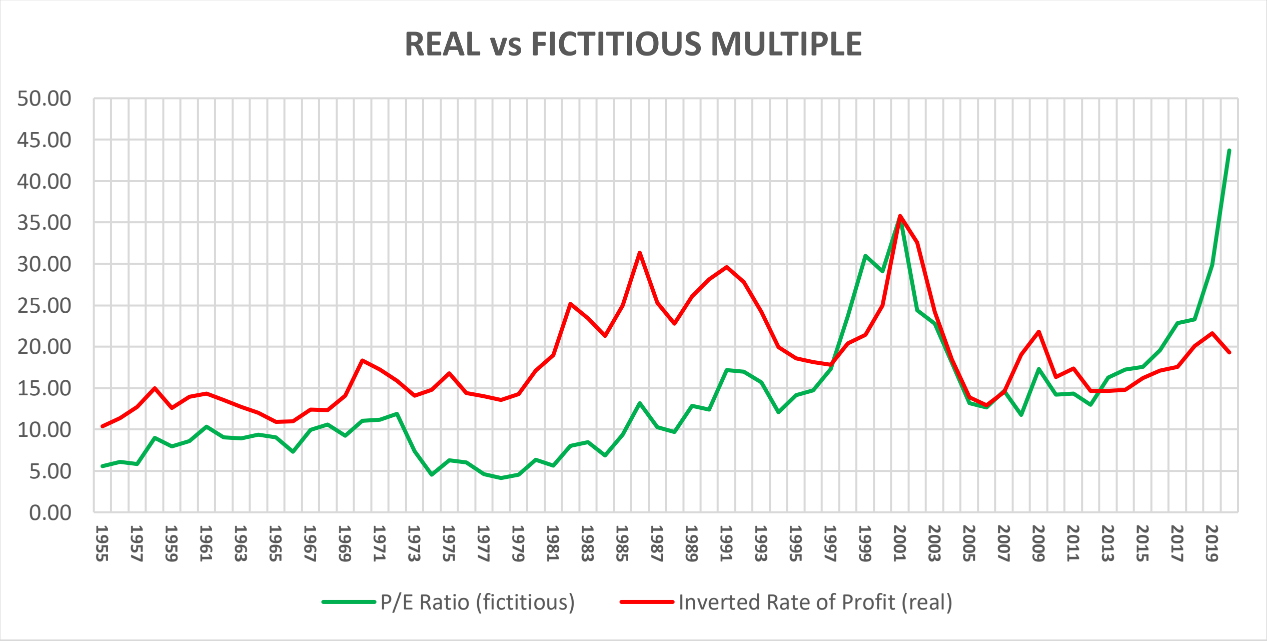
Graph 1. (FRED table WILL5000PR_20211104)



The result is that the fictitious multiple has swopped position with the real multiple (see Graph 2). When that happens markets enter bubble territory. This can be seen below. Prior to 1996 and the run up to the dotcom bubble, the real multiple on average was double that of the fictitious multiple hence the headline of 'healthy'. This is the normal state of affairs.

However, after 1996 and then again after 2012 and quantitative easing the biggest financial bubble in history emerges. By early 2020 it is the fictitious multiple that is almost double that of the real.

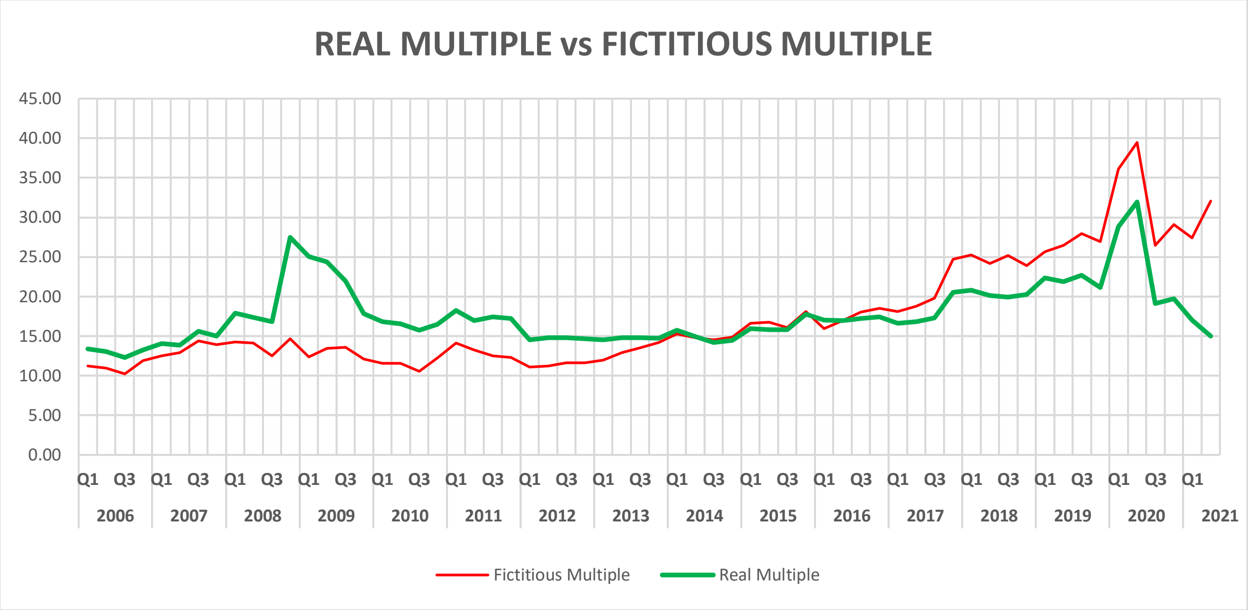
Graph 2. (NIPA Table 1.14)



This graph has been replaced due to the valuation of shares provided by the Federal Reserve which is to be found in the Table under Addendum. If gives a more accurate picture of the financial bubble.

In the graph below is a more up to date quarterly presentation of the multiples. The falls in the real multiple since Q2 2020 is confusing until we recall this is the distortions caused by the COVID fiscal subsidies which totalled $5 trillion, of which about a fifth was directed towards the corporations, boosting their profits directly and therefore their rates of profit. Because these are multiples a rise in the rate of profit results in a falling multiple. What is important is the gap. The gap has not closed. In fact in Q2 it was at its widest. The question is posed what happens when these subsidies no longer boost the rate of profit, as is about to happen in Quarter 3. (The preliminary estimate for corporate profits will be released on November 24th) There is unlikely to be a reduction between the two multiples. Here we remain more concerned with investigating whether or not the rise in fictitious capital impacts the real economy.

Graph 3.



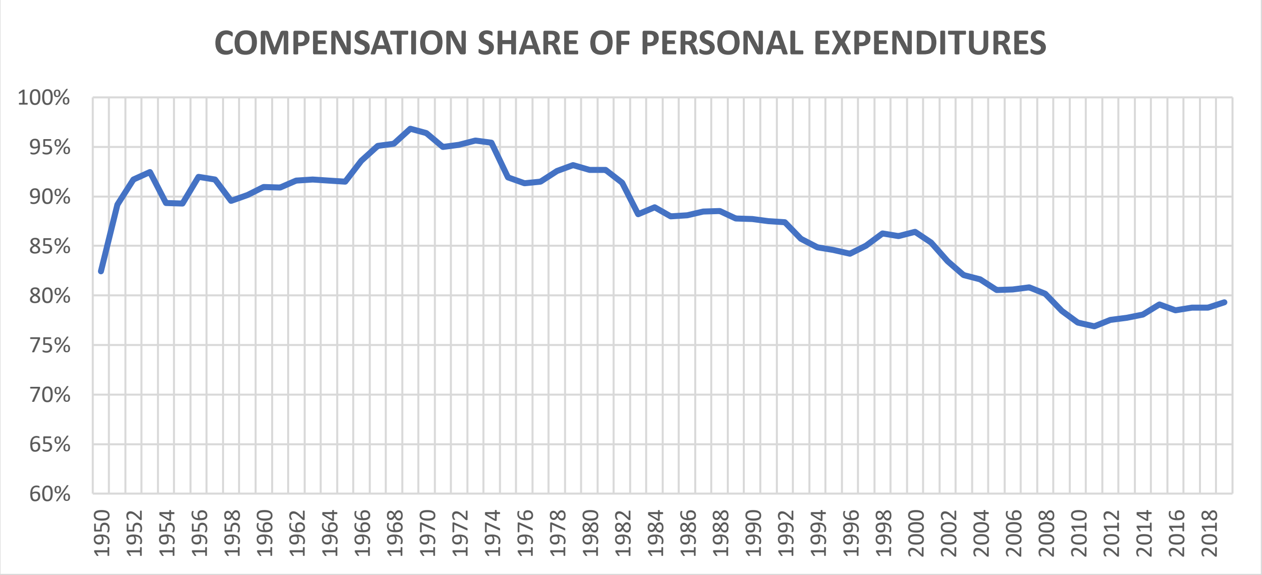
(This graph has been replaced.)

The Massachusetts Institute of Technology recently brought out a study which showed the migration of money from the fictitious to the real economy. It found that investors (ne speculators) tend to cash in about 3.2% of their holdings annually in order to spend it in the real economy. In the US, over the period beginning mid-2014, this would amount to 3.2% of $4.1 trillion annually as measured by the Willshire 5000. (In mid-2014 the market cap of the Willshire 5000 was just over $20 trillion compared to $48.5 trillion currently.) This difference of $28.5 trillion over 7 years amounts to a $131 billion spend p.a. or when we factor in other speculative markets e.g. bonds and mortgages and derivatives the figure is likely to be at least $160 billion (Shares currently represent 50% of US household financial wealth. (Note 1.) https://www.cnbc.com/2021/10/01/stocks-are-at-a-70-year-high-as-a-share-of-household-financial-wealth.html

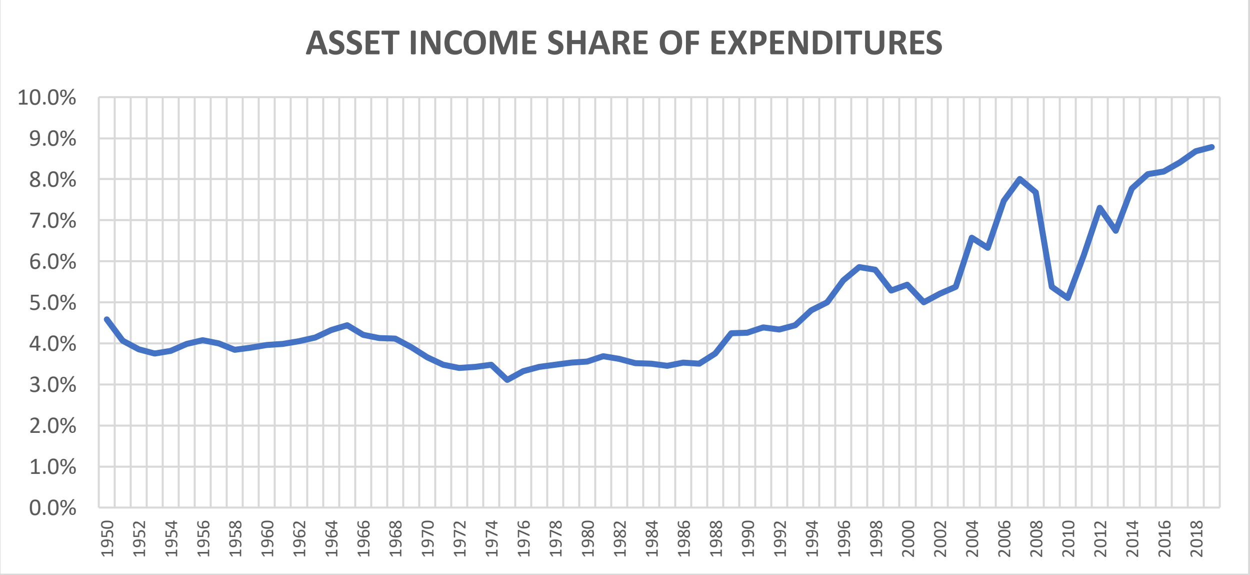
Set against GDP this accounts for at least 0.8% of its growth p.a. or 40% of the total GDP growth since 2014. In terms of the increase in consumer expenditures over 7 years it amounts to 51%. I put the figure closer to 60%, but nevertheless it does explain why capital gains acting via consumer expenditures has been a driver of GDP. (Note 2.) (GDP data derived from NBIPA Table 1.1.5) It is also worth noting that the cumulative growth in market derived spending is 5 times greater than that of fixed investment net of I.P.. Thus it is true to say that growth of the US economy was unhealthy because it was driven more by speculative gains and less by investment. https://scholar.harvard.edu/files/chodorow-reich/files/crns_published.pdf

The BEA correctly does not include capital gains in GDP. But statistically excluding it as we have seen above means there is no accounting for the significant leakage from the fictitious sphere into the real economy. Unfortunately because of the way the System of National Accounts is constructed it is impossible to extract this information directly. I know, I tried working NIPA Table 2.1 to destruction. The reason is that GDP is essentially the sum of final sales +- changes in inventories +- changes in foreign trade. So if final sales are at its core, then clearly that element of sales attributable to capital gains is already dissolved into total sales and cannot be distilled out. However, there were some observations derived from analysing Table 2.1 which are worth sharing.

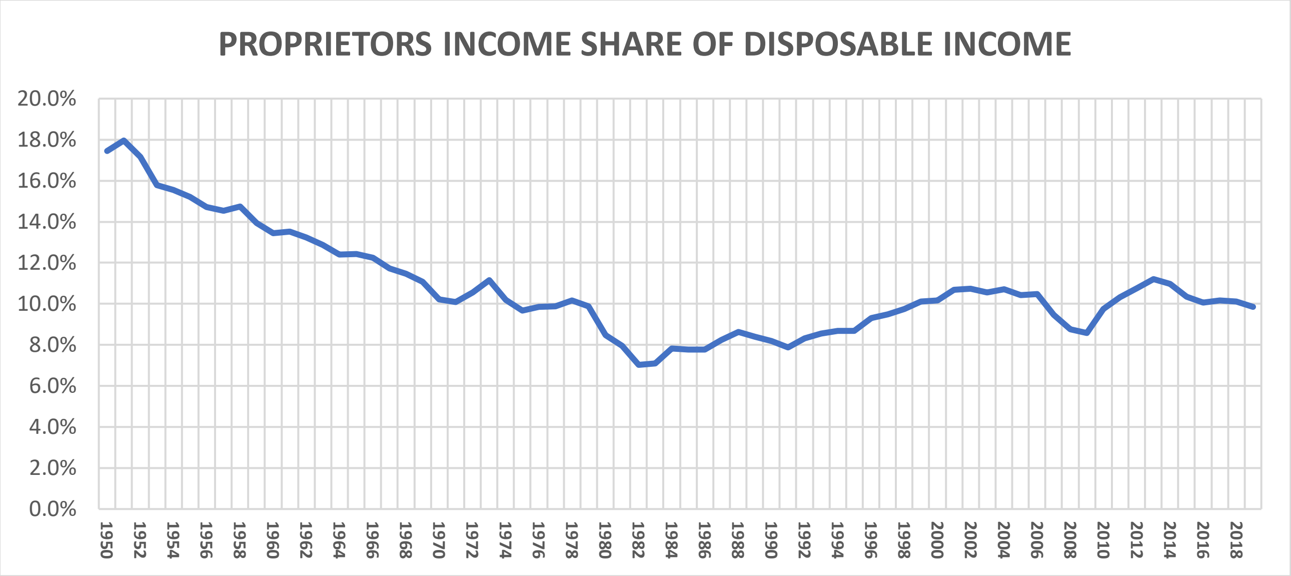
Graph 4. (NIPA Table 2.1)



Graph 5. (NIPA Table 2.1)



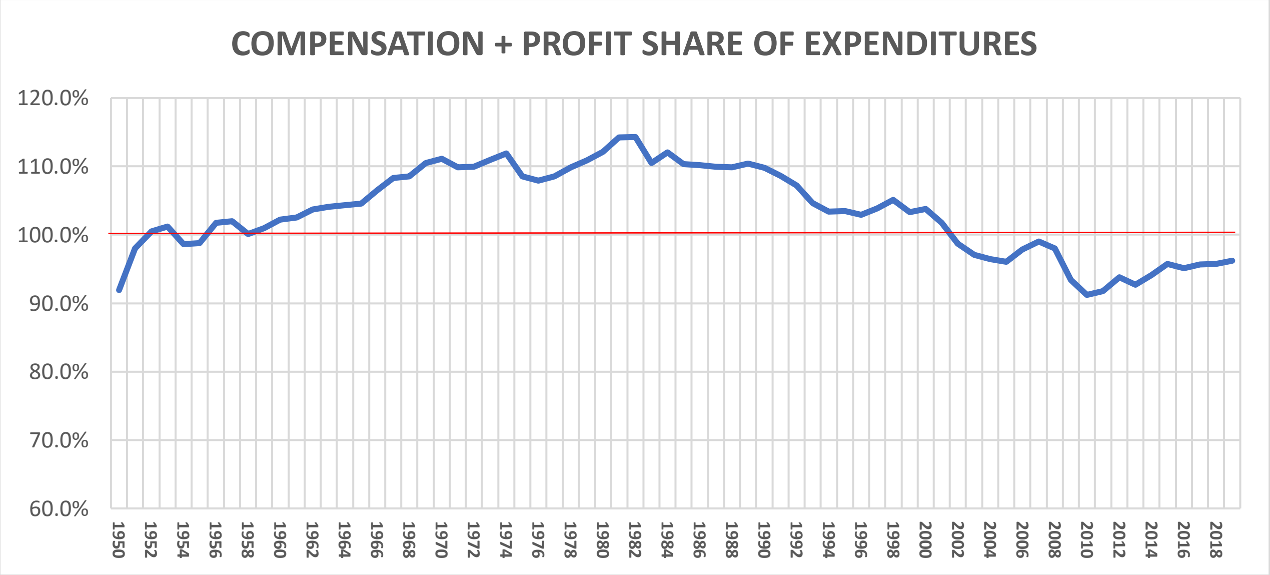
Graph 6.



We note that wage compensation as a share of personal consumption expenditures has fallen sharply, despite the wage rises of the top 1% who are the directors and officers of corporations. Conversely, the income from assets has risen while that of Proprietors has been more stable.

Interestingly when we add wages and profits together we do find they no longer cover expenditures. From a surplus of 10% they are currently 5% in deficit meaning that expenditures now exceed their combined income. This is of more than passing interest. While the BEA cannot account for capital gains "income" it has to record all expenditures because in the main they are real and therefore unavoidable. If we assume that because of capital gains converting to purchases, expenditures should outrun income net of capital gains, the graph below is an indication of this happening.

Graph 7.

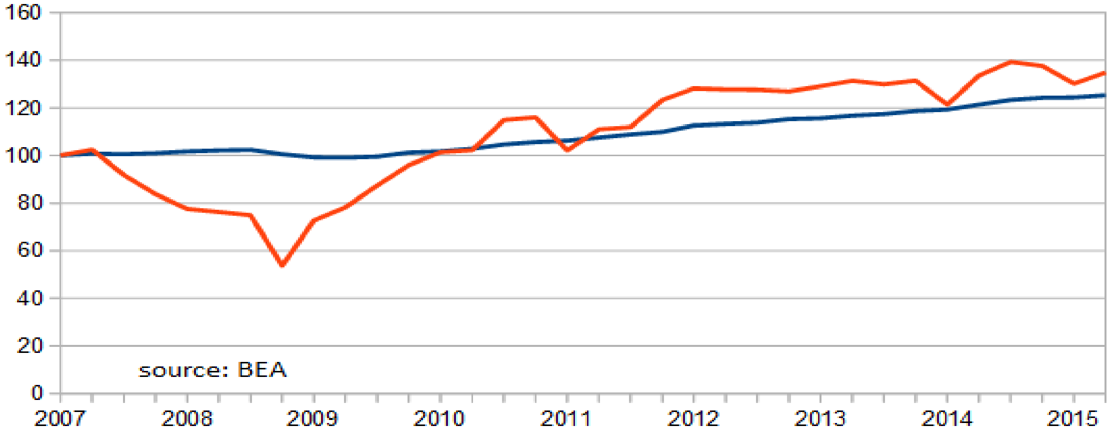


The outlook for profits.

While Wall Street has been celebrating the profit jamboree with headlines fuelled by non-GAAP comparisons with 2020 the real picture was not so rosy. With a few exceptions, when set against the previous Quarter, profits either fell or did not rise and profit margins were squeezed. I downloaded about 40 leading S&P 500 companies profit releases for the third quarter and where they included Q2 trading results this was confirmed.

There are a number of good reasons why quarter on quarter profit data will be negative, as opposed to last year at the height of the pandemic. Firstly as Michael Roberts has pointed out, there has been a close association since the financial crash between GDP growth and profit growth. Given that the most recently GDP quarterly growth was only 0.5% (and even this was overstated because of the overstatement of retail sales) there is not much scope for profits to grow.

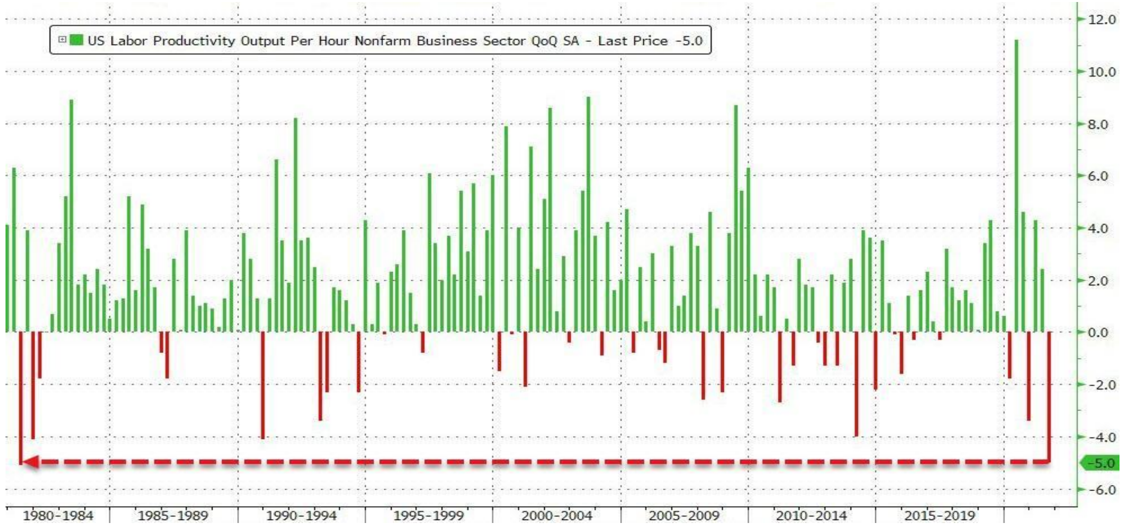
GRAPH 8. Corporate Profits (red line) vs. GDP (blue line) indexed to 2007



https://www.nasdaq.com/articles/what-relationship-between-corporate-profits-and-gdp-2015-10-30

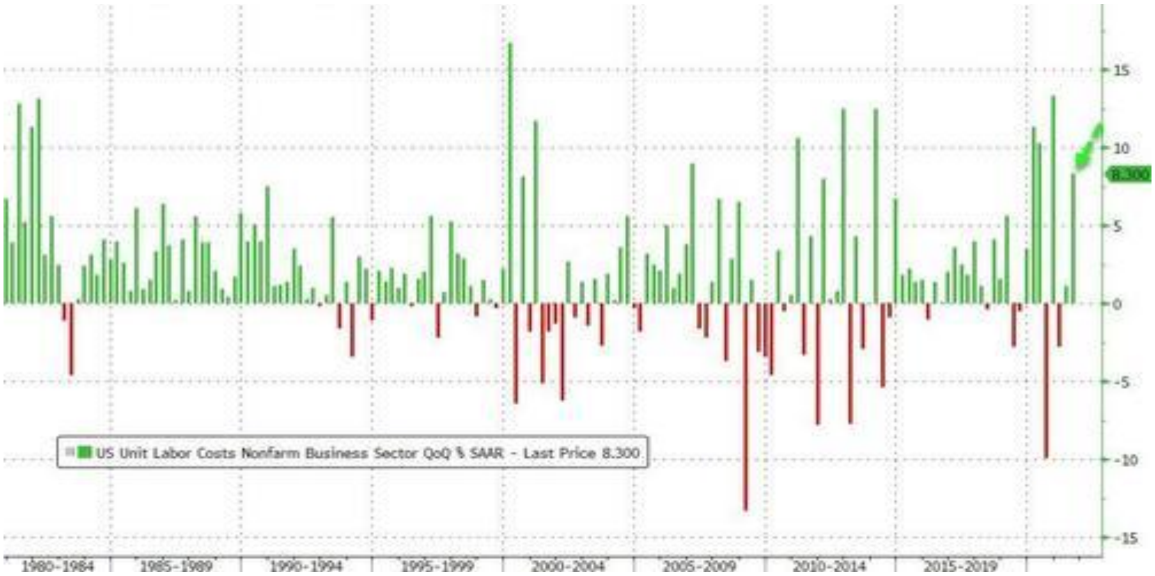
Secondly, the productivity and labour costs index for the third quarter showed the biggest fall in productivity since the early 1980s. A fall of 5%.

Graph 9.



And consequently labour costs rose 8%.

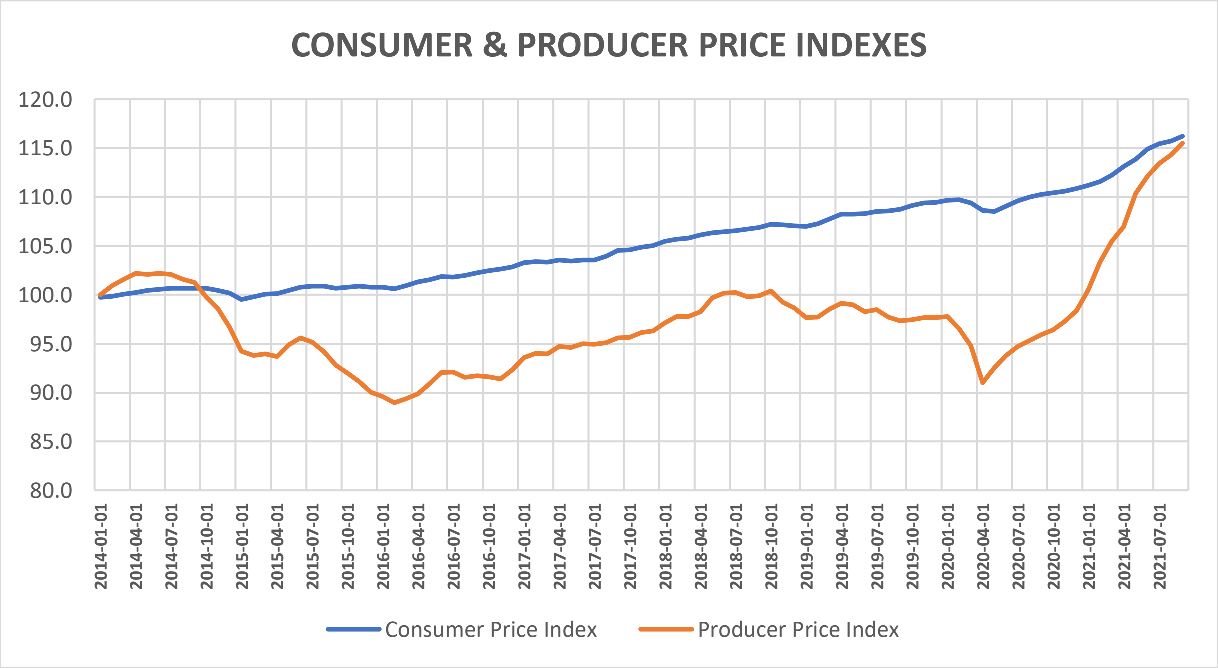
Graph 10.



(Both graphs courtesy of JP Morgan and the BLS https://www.bls.gov/news.release/eci.toc.htm)

A final factor for the profit margin squeeze is the disparity between selling prices as registered by the Consumer Price Index (CPI) and the buying prices as registered by the Producer Price Index (PPI). This year has seen a rise in the PPI of 20% compared to the CPI of only 5%. Together they form a vice squeezing profit margins.

Graph 11.



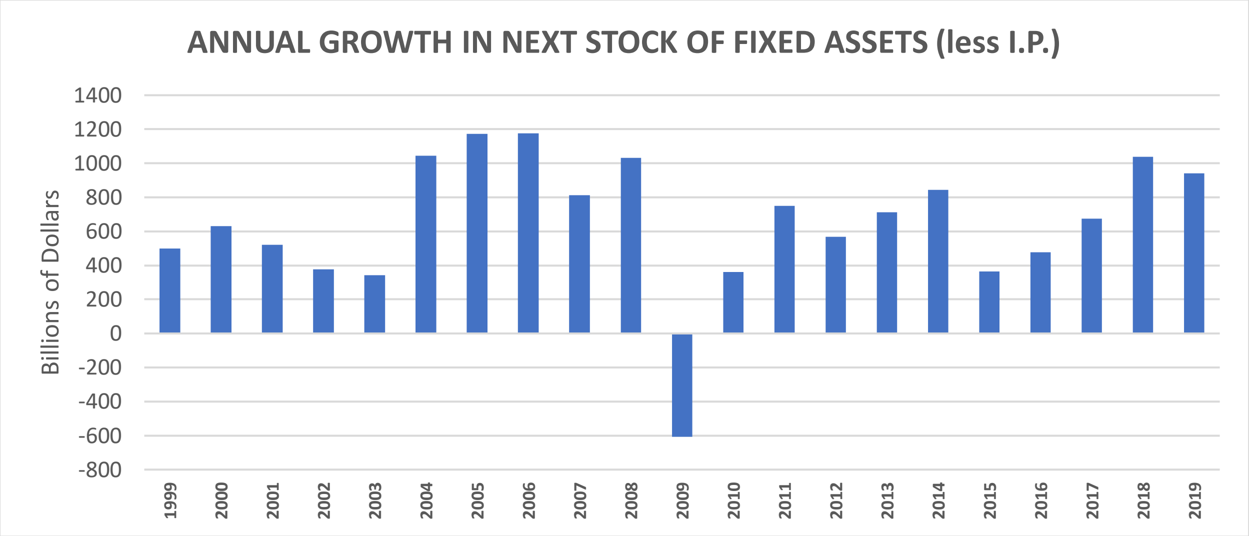
(Source FRED Tables CPIAUCSL for CPI & PPIACO for PPI)

A quick look at Biden's infrastructure plan.

Biden's infrastructure plan amounts to $1.2 trillion over 5 years or $240 billion annually (a third of what the US spends on its armies). The preliminary Congressional Budget Office says it will only increase the Federal deficit by $256 billion so less of a stimulus than the headline figure suggests. Nor is it in the same league as the Covid Relief Funds which added $5 trillion over 15 months.

How much of a boost will this fixed investment give the economy? Since 2014 annual net investment (excluding I.P.) has amounted to $724 billion for non-residential property. Thus $240 billion adds up to a boost of a third bringing net investment up to levels last seen before 2008. At just over 1% of GDP p.a. it is unlikely to be inflationary.

Graph 12.



(Source: Fixed Asset Table 4.1)

Conclusion.

We wait with bated breath for the release of the profit figures and the second estimate of US GDP towards the end of the month. But this should not distract us from the most important task at hand, supporting workers in struggle and defending those at the bottom of society suffering the twin blows of benefit cuts and swingeing inflation.

> Note 1. Of course to be rounded we need to acknowledge that there is a loss to the economy as well in the opposite direction when capitalists increase their investment in fictitious instruments. Given the rise in the savings rate which is a balancing item derived from income less spending, this appears to be the case as Graph 1 in the attached spreadsheet shows.
>
> Note 2. It is also the case that when the capitalists feel wealthier they spend more. This includes spending part of the proceeds of their dividends, interest, and rents. It is for this reason I assume that the figure of $160 billion is an understatement. Goldman Sachs reported in 2011 on their rich client spending habits and how it took 2 years of solid share price gains before their spending habits returned back to normal.

Addendum.

Yesterday the Federal Reserve issued its bi-annual November 2021 Financial Stability Report. What a contrast it makes compared to the tranquilising press conference given by Powell Chair of the FED quoted above. Far from being dynamic as the three quotes below show, the economy is fragile and unlikely to survive any shocks. As the quotes unfold, there is a sense that everything hinges on low interest rates. Accordingly, the one undisclosed shock would be a rise in interest rates. This report gives the game away. Forget about the twin arrows aimed at inflation and employment making up the FED mandate, it is all about preserving the financial bubble. Seems Jerome Hayden Powell speaks once again with a forked tongue. https://www.federalreserve.gov/publications/files/financial-stability-report-20211108.pdf

"Across most asset classes, valuation measures are high relative to historical norms. Since the May 2021 Financial Stability Report, equity prices rose further. While this increase is due, in part, to improved earnings expectations, the ratio of prices to forecasts of corporate earnings stands at the upper end of its historical distribution. Yields on long-term Treasury securities, corporate bonds, and leveraged loans remain at low levels relative to their historical ranges.

Risk compensation remains low across sectors, which is often associated with elevated investor risk appetite. Consequently, asset prices may be vulnerable to significant declines should risk appetite fall, progress on containing the virus disappoint, or the recovery stall.

Treasury yields are low relative to their historical ranges, and an increase in Treasury yields, if unaccompanied by a commensurate strengthening of the economic outlook, could put downward pressure on valuations in a variety of markets."

The Report also provided the following essential data which has caused me to rework Graphs 2 & 3 above to show the sheer scale of the financial bubble. (Data in report found in Table 1 page 10.)

US ASSETS VALUED IN TRILLIONS OF $s and growth rates.

	Outstanding Value $s	**Annual Growth % Q2 2019 – Q2 2020**	**Annual Growth % 1997 – Q2 2020**
Equities	54,768	47.2	10.1
Residential real estate	44,489	12.0	6.0
Commercial real estate	21,788	6.8	7.0
Treasury securities	21,699	9.2	8.2
Investment-grade corporate bonds	6,667	4.1	8.3
Farmland	2,597	1.6	5.1
High-yield and unrated corporate bonds	1,630	4.9	6.9
Leveraged loans*	1,258	6.2	14.2

Brian Green, 7th November 2021.