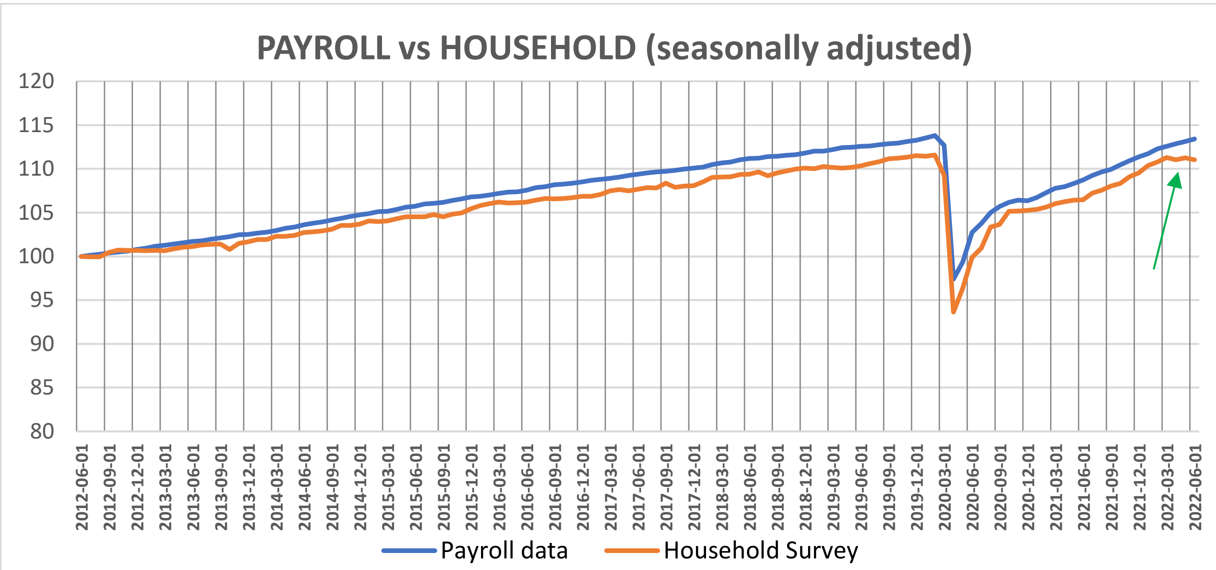
FED CHAIR POWELL SAYS THE US ECONOMY IS STRENGTHENING. LET'S PUT HIM TO THE TEST.

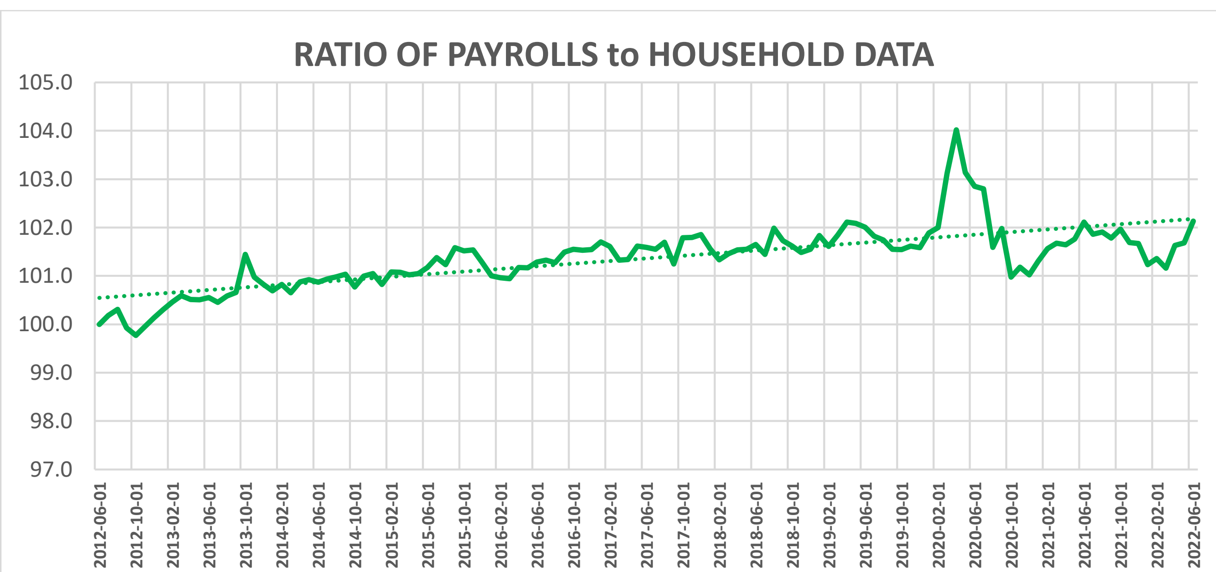
It was clear from May's data that the US economy was decelerating. There is now sufficient data from June to determine whether the economy's deceleration is accelerating so to speak, or not.

We will begin with the payroll data. June's headline figure surprised on the upside by rising 372,000. Cumulatively since March payrolls have risen by 1.125 million. This is the Establishment figure. However, since March, the Household Survey shows a 0.4 million contraction in jobs resulting in a difference of 1.5 million jobs, equal to 1% of the entire workforce. This discrepancy is shown up in the 2 graphs below. In Graph 1, moving right we see a constant rise in payroll data but a levelling off in household data.

Graph 1.



Graph 2.



The household data seems to be more in line with data from the much-cited ADP Hires Index. The discrepancy between its data and the household data is only 9 percent compared to over 14% for the BLS payroll data. Unfortunately because the ADP data disagreed with the BLS data, ADP has retired hurt, pausing its data while it examines its methodologies. Actually it is the BLS or the Bureau of Labour Statistics that should be examining its methodology. The household data is more aligned to the flurry of lay-offs and hiring freezes being announced by corporations small and large. These warnings include titans such as Meta and Google. Seems Hi-Tech is becoming Bye-Tech.

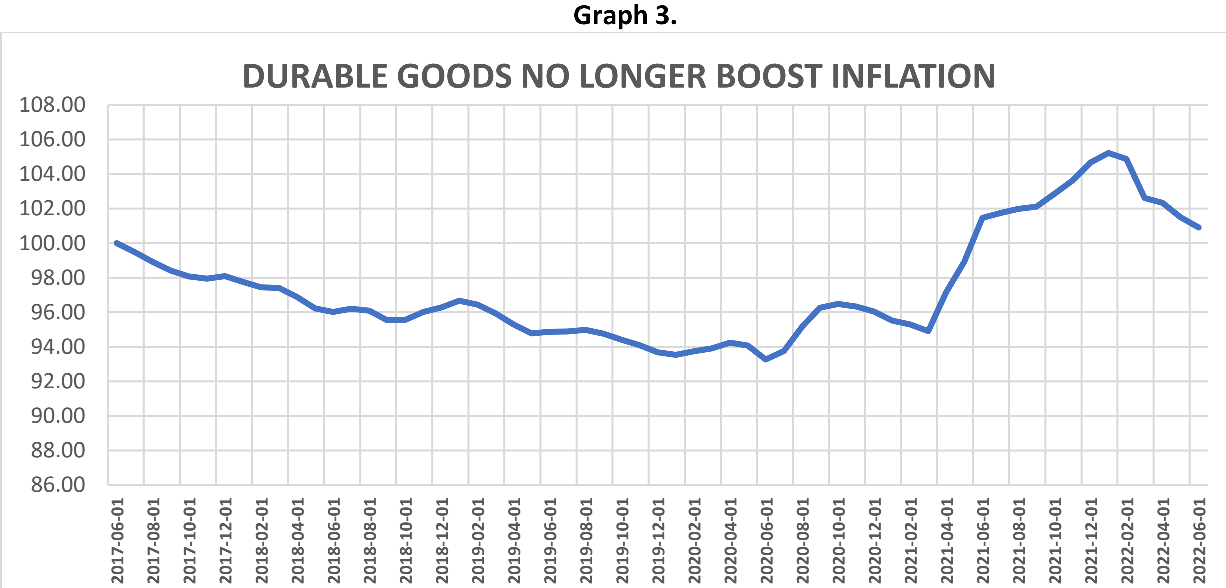
Another way of looking at the data is to use the [Congressional Budget Office] (CBO) monthly report. In Table 2, up to Feb 2022 the monthly (annualised) amount of employee withholding taxes averaged $267 billion, by June it had fallen to $262 billion a month. Adjusting for inflation in wages, this suggests a fall in employment, not a rise. (See Foreword.) This is in line with recent firings including in Hi-Tech.

In summation the actual labour market is much softer than the FED Chair believes it to be. Indeed the Fed Beige Book released on the 13th of July confirmed the household survey outlook. *"However, nearly all Districts noted modest improvements in labor availability amid weaker demand for workers, particularly among manufacturing and construction contacts."* There is a definite disconnect between the Chair of the FED and the reports produced by his team of regional FEDs.

Inflation.

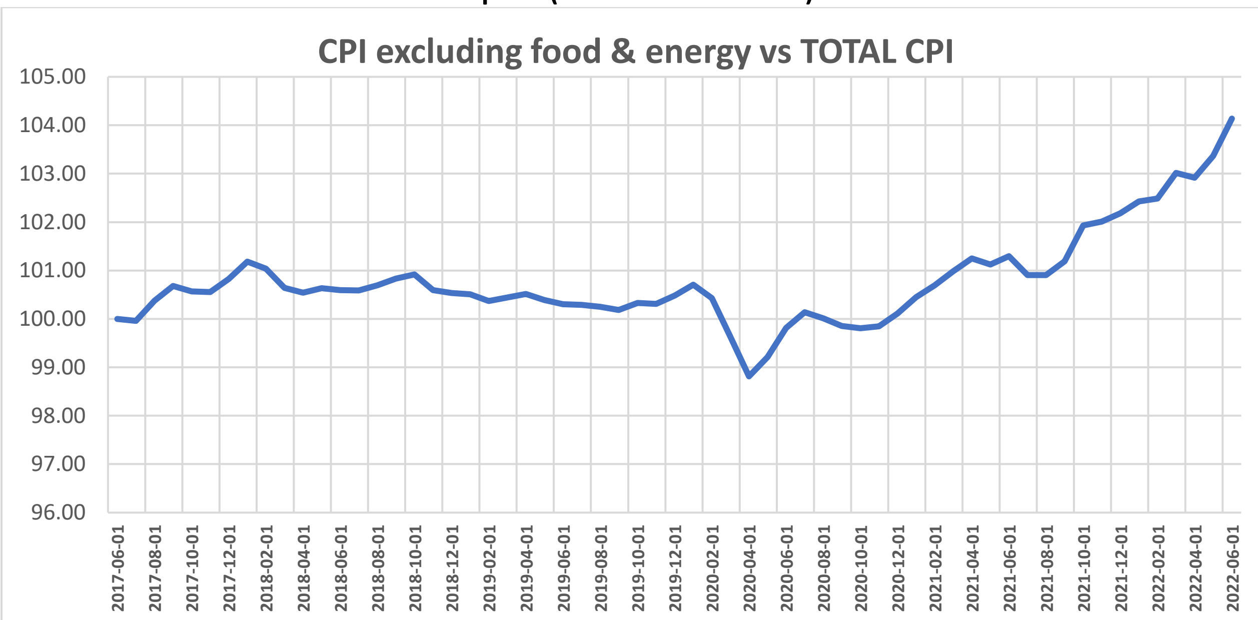
Inflation too surprised on the upside on Wednesday. The headline rate came in at 9.1%, above the 8.8% expected, and the highest rate for 30 years. Month on month it accelerated by 1.3% making it likely that another mistaken 0.75% FED interest rate hike is in the wings. Here are a number of graphs which shows that the driver of inflation has switched from the disrupted supply chain effect to the Ukrainian effect. The graph below shows durable goods inflation as a share of total consumer price inflation. We note that from March 2021 to January of 2022 it was the main driver of inflation due to supply chain disruptions. However since January it has given up half its contribution. In fact May-June 2022 prices on average are no higher than the January-February average. In other words there has been no increase in durable goods inflation despite the rise in new car prices now petering out.

Graph 3.



On the other hand when we look to Graph 4, we notice how energy and food prices have driven inflation. This graph compares inflation with and without energy and food. We notice that while durable goods inflation decelerated, food and energy accelerated. This acceleration kicked off in October 2021 and its momentum continued after the war in the Ukraine and subsequent embargoes on Russia.

Graph 4. (The Ukrainian Effect)



Looking at forward indicators for inflation. The oil price has retreated below $100 dollars on fears of recession. These commodities as they are known are sensitive to outlooks making them the ideal arena for speculation. If the speculators assume the global economy is weakening as it is now, they convert their bets from long to short, in other words they replace their bets on a rising oil price with bets on prices falling, which they are doing in greater numbers driving down the price of oil futures.

Graph 5. Brent Oil futures (CNBC)

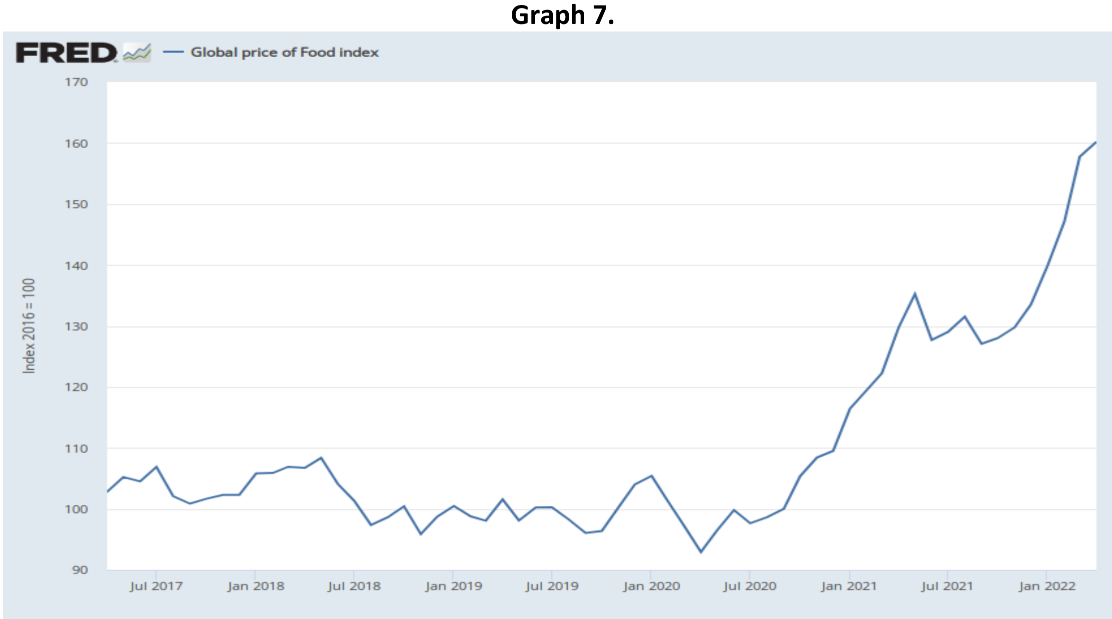
Alongside oil, the next most important commodity is Doctor Red, or copper. Like oil it too has succumbed to recessionary fears as the next graph shows. Adjusted for inflation the real price of copper is back to levels last seen in 2019. Both copper and oil prices are taken as at the 13th July.

Graph 6. Copper Futures (CNBC)

Finally, what about another key commodity, which in fact is a better indicator for investment decisions around the world. Nothing can be built without steel. And here we find an even bigger fall. Iron ore prices have halved since December 2021 when they stood at $220 for 62% fines. Thus industrially, there is little pipeline pressure and that includes computer chips which have recovered from the shortages caused by China and Russia vacuuming them up knowing that Western embargoes were in the pipeline so to speak.

This leaves food prices, the second driver of inflation. Since the outbreak of the pandemic they have risen a staggering 60%.

Graph 7.



Of all the commodities, agricultural commodities are the most difficult to predict particularly during the age of global warming with its higher incidence of adverse weather conditions. What therefore is the current outlook for Agriculture? According to the authoritative USDA World Agricultural Production report issued on the 12th July, global forecasts in June, though down on its May figure, was still only a couple of percent shy of its 2021 figure. Thus according to this report production unadjusted for restricted calories (embargoed food) is not in crisis. However, no sooner had the report been issued then concerns were being raised about the crucial US corn crop because of the growing heat and lack of rainfall.

The earliest assessment of global temperatures for June were grim. "*The globe just had the third warmest June on record, according to Europe's Copernicus Climate Change Service, with widespread episodes of extreme heat. Antarctic sea ice was the lowest on record for the month of June*." Thus it is too early to rule out weather induced crop disasters in the Northern Hemisphere this year as we are only half-way through the growing season. This means a balanced conclusion which includes the weather, the ongoing high cost of diesel and the shortage of fertilisers suggests the risks to higher food prices, unlike energy prices, remains elevated. The only good news is that progress is being made to ship Ukrainian grains via the Black Sea, which could be a dress rehearsal for much needed peace talks.

This brings us to the trillion-dollar question, is it excess demand fuelled by wage rises or insufficient supply which is driving inflation. Michael Roberts on his website *thenextrecession.wordpress.com* has dealt with this issue satisfactorily and his conclusion, that much of the inflation has been caused by profit gouging not wage rises, are robust. I therefore do not intend to duplicate what he has investigated except to say that the large corporations who have feasted on inflation thereby bankrupting their customers will pay dearly for their greed in the months to come as profit margins collapse.

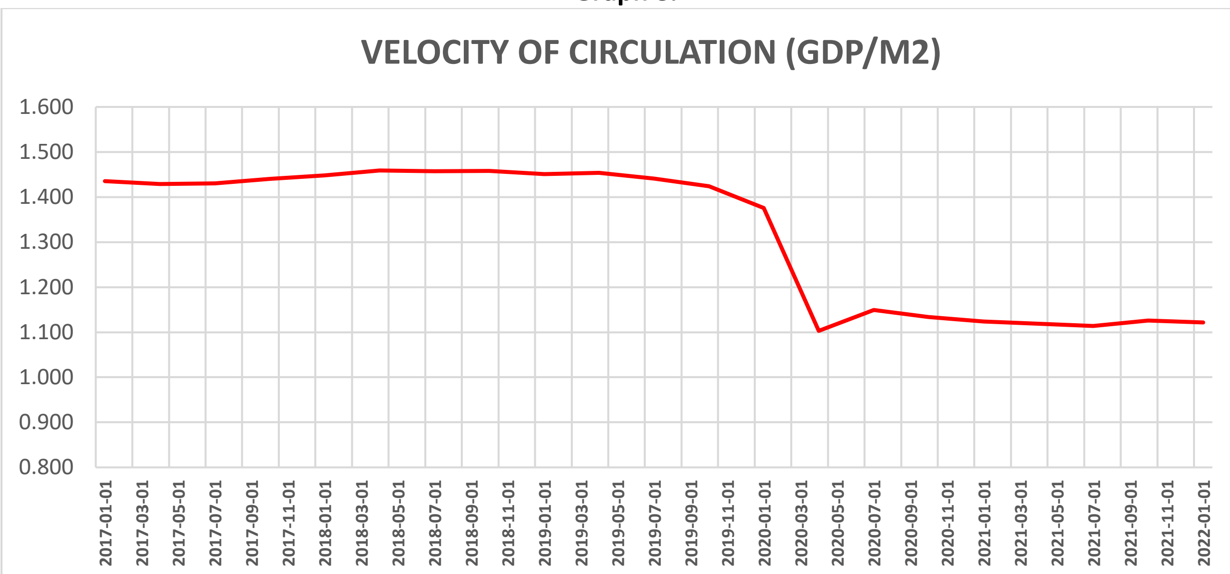
Instead I wish to deal with the issue of inflation at a more fundamental level. Readers may be aware of my novel hypothesis of modern money which I called Modern Marxist Monetary Theory or MMMT. MMMT investigates the role of token money and explains how it is able to serve as the embodiment of social value because it acts as the intermediatory between legacy value in the form of previously produced revenue and newly produced value. In short, prior monetised revenue is exchanged for current output, as a result of which the previous revenue is extinguished while new revenue is created. Thus in the reciprocal motion of past and present revenue, money is the essential rotor or hub.

More concretely I address the composition of the money supply or M2 using the prism of legacy value. These investigations can be found here and here. The bulk of M2 comprises unspent legacy value in the form of deposited revenue. In times of price stability this component makes up between 90 and 92% of total M2, with the balance of around 8 – 10% consisting of an increase in temporary money (bank credit in its loan form), an increase in permanent money (fiscal deficits & QE) and finally the net leakages between the real economy and the world of speculation. (Foreign flows are excluded from this analysis.)

It should be recognised that legacy value is produced value, therefore real, and its quantity is previously fixed. It therefore acts as the ballast keeping prices upright. Should its share of M2 plunge as it did during Covid, due to the combination of a collapse in the output of value coupled to the spike in fiscal spending, (COVID relief funds) it portents inflationary conditions. Conversely should its share rise above 92% of M2 then it is likely to give rise to deflationary conditions because this implies an increase in unspent revenue.

The current situation is that unspent revenues have risen to well above 92%. On a running quarterly basis, M2 is currently $5415 billion while the Budget Deficit is $49.3 trillion and new Bank Credit is $340 billion making 7.2% of the total. The emergence of QT or Quantitative Tightening (the opposite of QE) together with collapsing share and bond markets, makes for a negative contribution to M2 from these sources. This is probably in the order of 2% bringing unspent revenues up to around 95% of total M2. This seems to be corroborated by the deceleration of M2 itself, always an indicator of the rise in unspent revenues and a much better indicator of the level of savings compared to the official savings rate in the national accounts which is not a real number but a balancing item. It should also be pointed out that the velocity has not decreased because of an increase in M2, as its annual increase of 6.5% is actually less than inflation itself.

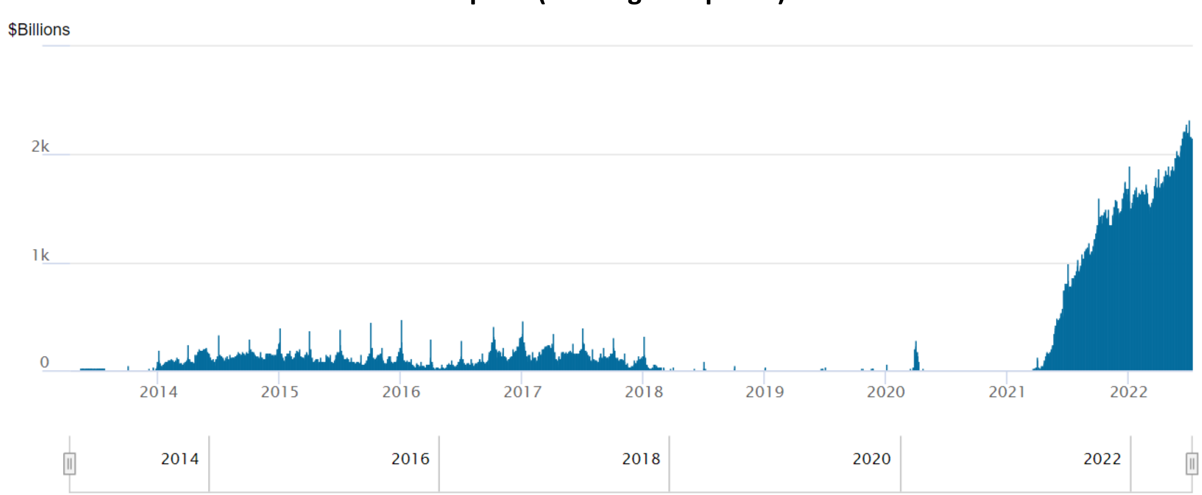
Graph 8.



(Source: FRED Table M2V)

Two additional points need to be made. Firstly to note that the budget deficit in the USA is currently running below its 2019 level. So much for the Biden Administration intervening to improve things. Secondly, despite the talk of liquidity tightening there is trillions of un-investable dollars sloshing around. Much of it is to be found in the Reverse-REPO Market. There is now over $2 trillion lodged in this market according to the New York FED who manage it.

Graph 9. (Overnight deposits)



The Reverse Repo story gets worse. Now that interest rates are rising so is the overnight interest paid by the FED. Whereas the rate was close to 0% up to April it is now at 1.56% annualised and it will rise as the FED rate rises. This means the banks, the hedge funds, and all the other overloaded investors stand to make a risk-free return of up to $40 billion annualised on reverse REPOs. Another gift to the banksters from the tax-payer.

In conclusion, from the demand side there is no pull-on inflation. Instead subdued demand globally is dampening inflation. What is causing inflation to remain high is residual pipeline inflation (high Producer Input Prices) sometimes supported by supply chain disruptions especially in transport. This is declining. As CNBC Reported on 10th July "*Spot ocean freight rates between China and major U.S. and European markets are falling as consumer demand retreats*". Even the much-hyped chip shortage is over with an increasing number of corporations cancelling or scaling back their orders as EPSNews observed: "*In total, these 10 companies posted a 5 percent drop in June sales as compared to May, with three of the four largest companies, including TSMC, registering a decline," IC Insights reported. "Particularly worrisome is the steep 26 percent decline in the June/May sales by previous 'high-flyer' Novatek."* The car industry is about to be found out. Their excuse about chip shortages which was used to sell the most up-market and highest margin models is about to blow up in their faces as consumers demand more fuel-efficient cars with less electronic frills.

Barring the wildcard of food, it appears that peak inflation has been reached which is why the markets fell by less than 1% when the consumer price index surprise was announced on Wednesday.

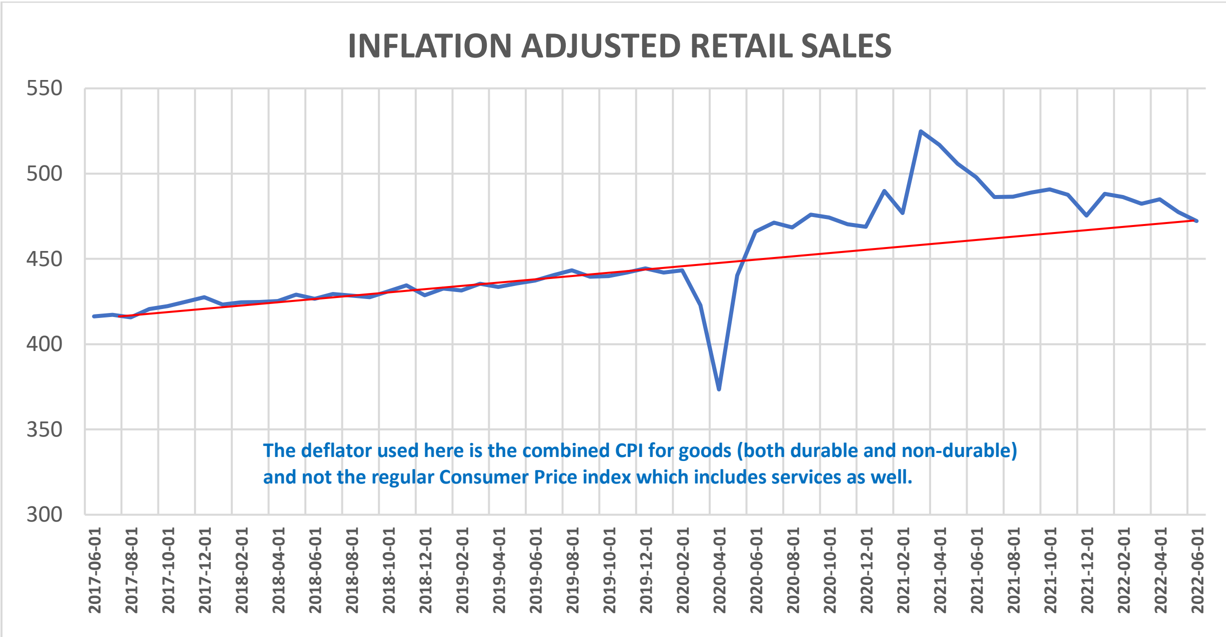
Will interest rates ameliorate the demand supply axis. In fact it could have the opposite effect, that is it could have unintended consequences, because higher interest rates will worsen not improve the supply problems when it drives indebted producers into bankruptcy. This is what happens when quacks deliver the wrong medicine. Instead of interest rate rises, a peace deal in the Ukraine is needed, but this wont happen because just as Zelensky sacrificed his people to the cause of imperialism, so the US and EU leaders will sacrifice their workers in pursuit of global domination. This is an indicator of just how ruthless our oppressors are and how spinless their political underlings are.

Retail sales.

The Beige Book had this to say about the level of demand. "*Economic activity expanded at a modest pace, on balance, since mid-May; however, several Districts reported growing signs of a slowdown in demand, and contacts in five Districts noted concerns over an increased risk of a recession. Most Districts reported that consumer spending moderated as higher food and gas prices diminished households' discretionary income."* The New York Tax Authority added that tax takings, which are dependent on sales and activity in the markets, had fallen to 2017 levels which in inflation adjusted terms was a fall of 20%. And the New York Tax Authority was not the only City reporting a fall in tax revenues. The CASS Freight Index showed non-adjusted freight shipments down YoY by an average of 2.5% in May-June, and as we know, what is not shipped is unsellable. Finally, this is the mood of small businesses in June: *"National Federation of Independent Business (NFIB) showed optimism dropped 3.6 points in June to a reading of 89.5 a thirteen-year low. The survey also found that small business owners expecting better business conditions over the next six months decreased seven points to a net negative 61%, the lowest level recorded in the survey's 48-year history. Expectations for better business conditions have worsened every month this year."*

So how did retail sales perform in June?

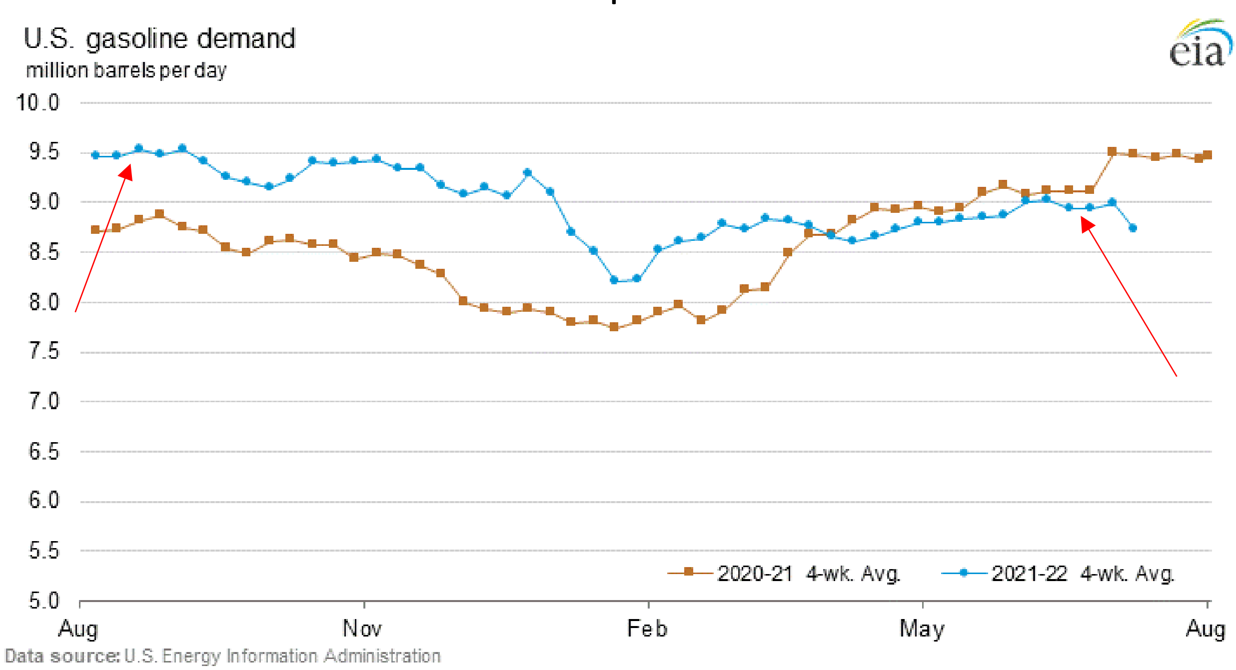
Graph 10.



Retail sales rose by 1% in nominal terms (typically overstated) but still fell by 1% in real terms. Honest gov, the adjustments by the US Census Bureau are unprovoked. June sales despite it all, like a precision guided metric, was bang on the 5-year trend. Shades of 2008. Annually there was no growth while June sales were down 10% from their high in 2021, but they were up 7% from 2019, believe that if you will.

Gasoline sales reveals the disparity between *nominal* and *real* sales found in the MARTS release on Friday. Adjusted gasoline sales which increased by 49% YoY was responsible for 40% of the increase in sales due to a hike in oil prices. Yet looking at the EIA Graph below, the volume of sales is actually down over 5%.

Graph 11.

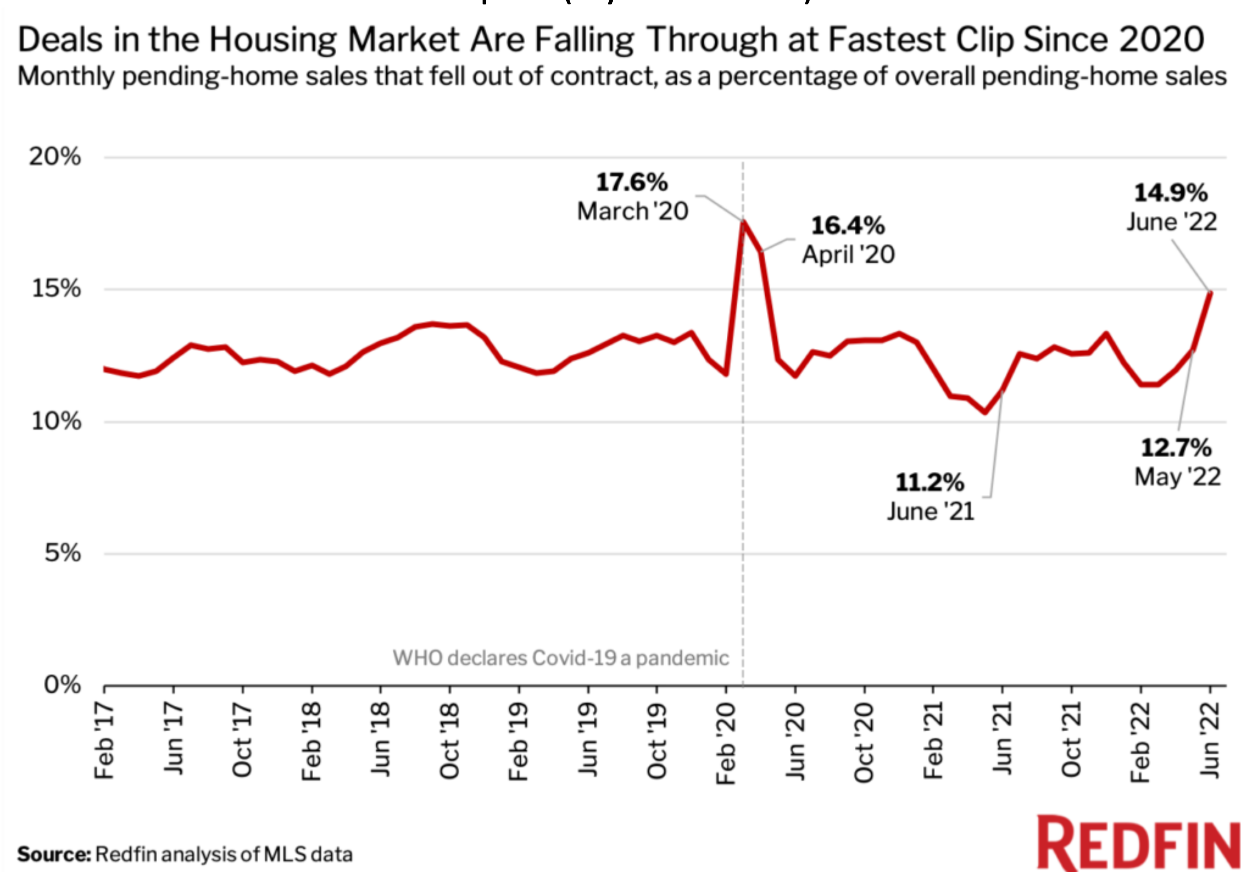


In times past I would assemble data from a dozen or so major retailers and aggregate their year-on-year sales revenue. Recently, I have found no correlation between their sales data and the sales data issued by the Census Bureau. In all cases, revenue results from these giants which represent at least 25% of total retail sales have undershot the data provided by the Census Bureau. I am disinclined to repeat this laborious investigation for the 2nd quarter of 2022 as I deem it unnecessary. On the basis that manufacturing is falling, inventories are rising, and imports are contracting, I remain convinced the retail data is highly likely to be overstated. This means that the fall in real GDP is greater than that posited by the Atlanta Fed in its GDPNow Cast cited at the end.

Housing & Junk Bonds.

Subsidence continued to hit the housing market. Applications for mortgage continue to tumble, and taken together with buyers doing a U-turn and walking away from their contracts, this is ominous for the housing market.

Graph 10. (Buyers do a runner)

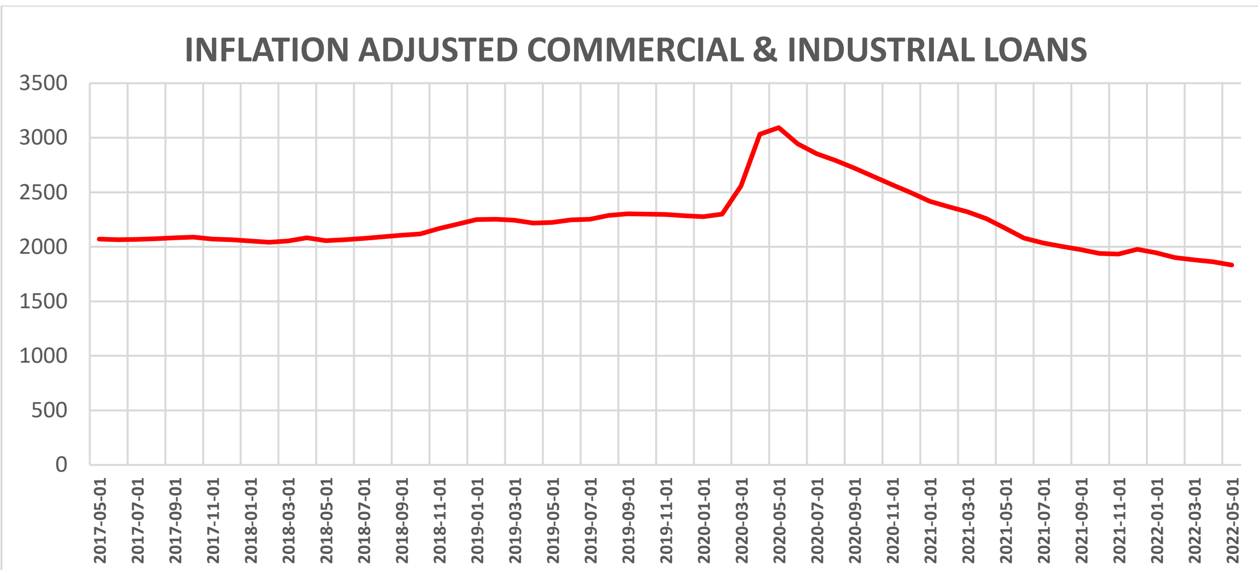


According to REDFIN the near 15% rejection figure in June was the highest on record barring the crisis period at the beginning of the pandemic. And of note, the rejection rate was highest in the hottest housing markets in key cities. Despite this rejection rate, analysts do not predict a house price crash this year, only a moderation. The same complacency was evident before 2008.

Turning to High Yield Bonds. June saw the first evidence of growing distress moving beyond the far corners of the high yield market as NOMURA reported. "*US High Yield capitulated to the slowing economy in June,* *with the market declining -6.81% on the month and -14.03% in the first half of the year, as measured by the ICE BofA US High Yield Constrained Index (HUC0). High yield spreads gave way as 1H22 came to a close, jumping 166 bps on the month to 589 bps. Yield to worst increased 181 bps to 8.95% as of the end of June. Year to date, spreads are 278 bps wider and yields have increased by 462 bps."* Similar falls were experienced in Europe.

However, in the interest of balance, we must take into account that trade credit, the biggest form of credit, is not yet in crisis. This can be seen in the graph below based on data which is admittedly a month old. This graph plots short term loans to the productive and distributive sectors. It generally rises as trade credit falters forcing producers and traders to head for their banks to beg for short term loans to improve their liquidity. Hence the jump in 2020 when the pandemic froze everything and before the US Administration pumped Relief Funds into the economy.

Graph 11.



Finally, on credit, the inversion between 2-year and 10-year bonds continued to deepen as the week progressed. At 25 basis points it was deeper than the period preceding 2008 and the second deepest since the Volcker 200 basis point inversion (1980s). However, the more important 3-month 10-year inversion is yet to take place. These inversions are usually associated with the onset of recession. <u>Generally as well, when these inversions are also associated with a spike in Commercial and Industrial Loans, a recession is certain and imminent.</u>

The same distress was evident in emerging market funds as NOMURA added*: "The EMBIG index' performance during the first half of the year was the worst since the 1H13 "Taper Tantrum," also driven by Fed tightening expectations following a long period of accommodative monetary policy. With the price action in June, the EMBIG index spread over US Treasuries widened by 129 bps to 460 bps, mostly driven by high yield credits that on average repriced to yields around 12%. EM high yield corporate bonds, as measured by the ICE BofA High Yield US Emerging Markets Corporate Plus Index (EMUH), declined -6.51% in June and -19.28% YTD. EM outflows hit $50 billion this year so far. On track to be biggest outflow for 17 years. Already worse than in 2015 when concerns about China were elevated."*

And in China itself small scale riots by investors erupted objecting to paying for mortgages on properties not being built. It is clear that China, despite its over-large state banks, is facing the same debt distress as is found elsewhere. For the first time personal debt is beginning to rear up as recessionary conditions take hold. I will return to this observation in a future article.

Conclusion.

The retail and industrial data (where production fell unexpectedly) shows that the US economy is not strengthening but weakening Mr Powell, despite the unprovoked (1) positive adjustments. The latest release of the Atlanta FED GDPNow report issued this Friday puts Q2 contraction at 1.5% slightly down from its previous July 8 report. The economy remains on course for a second quarterly contraction.

The Financial Times carried a perceptive article titled: America Risks an Emerging Market Future. It focuses on the research by "*Mark Rosenberg, founder and co-head of the research firm GeoQuant, who has been tracking various measures of political risk in America and numerous other countries on a daily basis since January 2013. In a recent client letter, he noted that, as it celebrated Independence Day on July 4, the country hit a new high in political risk. This was driven by increases in sub-indicators including governance risk, social risk and security risk*." He traces this malaise which he calls the *"EM-ification" of US politics*" and which he defines as: "*a less stable form of political conflict in which institutions are too weak to clearly define or enforce the rules, increasing social polarisation as well as political and economic uncertainty around key political events*" back to 2008. He now rates the USA, 85 out of 127 countries making it the highest risked major economy.

The developments in the economy will only deepen the low-grade civil war that has emerged in the country exemplified by the January 6th events last year outside the Capitol. Currently the country is being governed by the Supreme Court. This 'gerrymandered for life institution' has been hijacked by about 20% of US society made up of a coalition or better still a clique of right-wing religious folk holding the rest of society to ransom especially women.

It is against this background that we should ask whether Ukraine will become the 1905 moment for the USA, as it did once before for an earlier imploding empire. That's how Empires collapse, and revolutions emerge.

Brian Green 15th July 2022.

(1) The reason I used the term unprovoked is to tie it into the often-repeated assertion by the Imperialists that the Russian invasion of the Ukraine was *unprovoked* when the opposite was clearly the case. Similarly with seasonal adjustments and revisions which have been favourably and possibly fraudulently politicised but at the cost of errors in policy. This will be seen over time.