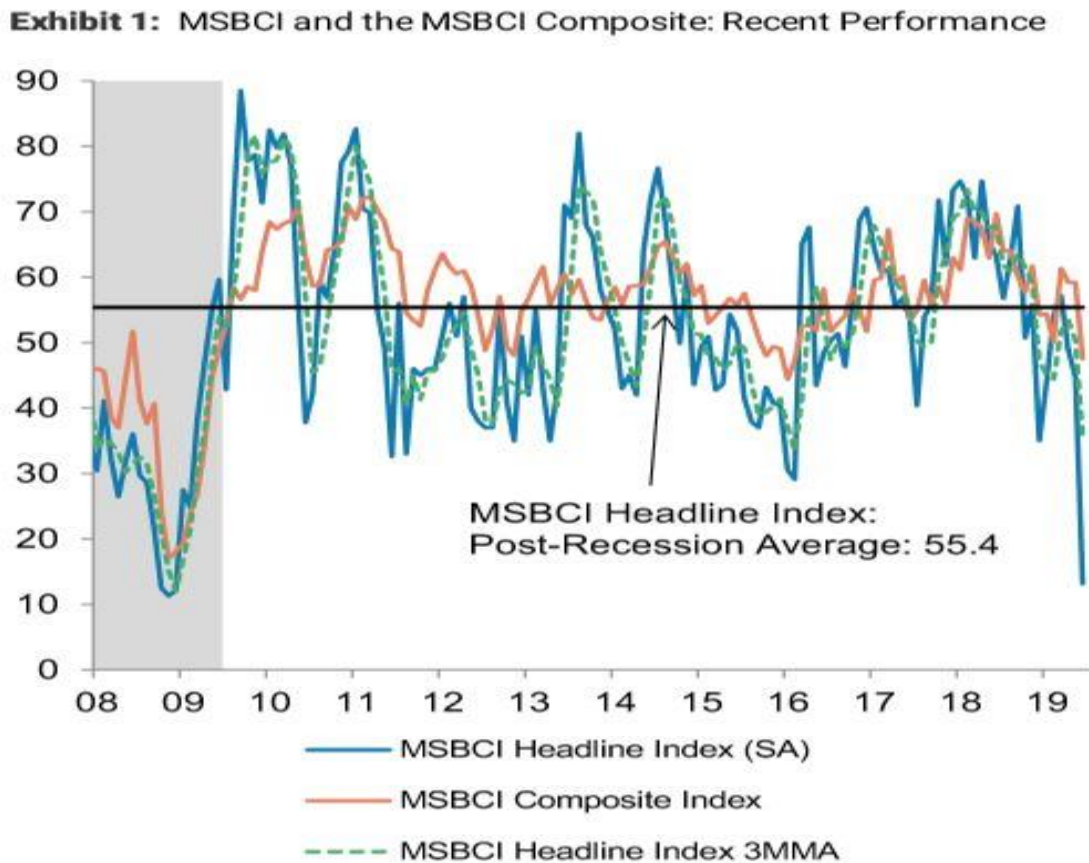


## PANIC, WHAT PANIC.

*What distinguishes the Crash of 2019 from the Crash of 2008 is the messianic belief that the Central Banks will pre-empt a credit emergency. This is based on an assessment of the interventions by Central Banks post-2008 and the lessons learnt from 2008. This post argues this belief maybe misplaced.*

The actual conditions in the world economy are approaching the level of 2009, the trough following the financial emergency of 2008 when credit seized up. A credit emergency is a panic when investors all rush for the exit simultaneously, creditors force repayments and sellers demand cash for their goods. The panic multiplies the damage already done to the economy from the collapse in investment. It is analogous to the body suffering a wound. Doctors will explain that the immune system scavenges not only dead tissue but surrounding tissue as well, before it is switches off so that repair or reforming can take place. So too with a panic. Prices are driven well below the point the actual devaluation of capital requires which is why they bounce up so soon as the emergency is resolved.

Below is J P Morgan assessment of current business conditions in the USA as reported by CNBC on the 13<sup>th</sup> June. This is followed by a graph highlighting the index. *“The Morgan Stanley Business Conditions Index fell by 32 points in June, to a level of 13 from a level of 45 in May. This drop is the largest one-month decline on record. Every sub-index of the Business Conditions Composite fell in June, except for the credit condition category, which ‘is consistent with the recent easing in broad financial conditions,’ Zentner said. The manufacturing subindex business conditions fell sharply to zero.... ‘marking the lowest level for the subindex on record,’”* Zentner said. (Source: <https://www.cnbc.com/2019/06/13/a-morgan-stanley-reading-on-the-economy-collapses-by-the-most-ever.html>)



Source: Morgan Stanley Research

A number of issues arise. The June index fell the most on record. The manufacturing sub-index fell to the lowest level on record. But the only component that did not fall was the credit component because of the easing in credit conditions. Generally, this level of distress is not consistent with an improvement in credit conditions.

This index captures all aspects of activity. *“June’s conditions index reading showed notable declines in hiring, hiring plans, capex plans and business conditions exceptions, Morgan Stanley said.”* It is important for predicting turning points in the economy. The last time the index sunk so low was December 2018. But no panic.


### **The role of credit.**

It is always important to remember that workers do not produce interest directly. They produce gross or undivided profits. Interest and rent is a deduction from these profits. It represents the redistribution of some of the profit from the industrial or commercial capitalist to the money lender for the use of money (interest), to the landlord for the use of the land (rent) and we may add, tax to the government. What remains is enterprise profit. Thus, in terms of revenue, profits are the primary source of revenue, with interest and rent being secondary sources.

The rate of profit and the rate of interest are connected. When the rate of profit is at its highest, rates of interest are at their lowest. The reason for this is that during the phase of prosperity (Marx) when the mass of profit has expanded to its fullest extent, corporations fund most of their needs from internally generated cash flows. This is the phase when they are least dependent on external funds, loan capital. Consequently, as the demand for these funds fall, so too does the rate of interest.

This is little understood by contemporary Marxists. Between 1996 and 2014, globalisation, interrupted admittedly by the financial crisis in 2008, represented an extended period of prosperity at least for the multi-nationals that dominated this process. That is the reason why interest rates were so low for so long. The action of central banks after 2008 did not produce this state of affairs. Rather their policies added to it.

The opposite happens when the relative rate of profit plunges as it does at the end of the industrial cycle when turnover decelerates because of the fall in the investment in fixed assets. Now there is an urgent reliance on external funds to stay solvent. The demand for bank credit and money shoots up and with it interest rates. It is this collision between falling profitability and rising interest rates that precipitates the credit emergency that normally marks the onset of a recession.

This has not happened this time around despite the end of the industrial cycle. As the JPM report above shows credit conditions remain benign. Does this mean the classical V shaped recession will be avoided and replaced by a  shaped recession, shallower but longer in duration? It is entirely possible as Japan has shown.

It all depends on profits. Currently the world is in a profit recession. With each week FactSet is reducing its S&P 500 profits outlook for the second quarter. *“If -2.5% is the actual decline for the quarter, it will mark the first time the index has reported two straight quarters of year-over-year declines in earnings since Q1 2016 and Q2 2016”*. Interestingly, quarter 3 is now expected to also show no profit growth. [https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight\\_061419.pdf](https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_061419.pdf)

Actual US corporate profits may in fact be worse than stated. The corporate tax take is often a good guide to underlying profits. The US Treasury expected a fall in the corporate tax take of 18% due to the new tax law. Instead it fell by 31%. This year the treasury expected a rebound of 20%, instead they

fell by 8.7%. Of course, corporations could have discovered more deductibles and loopholes unforeseen by legislators. More likely, underlying profits have fallen further and for longer than anticipated.

It is said that Japan could have avoided its lost decade if the Bank of Japan had acted more quickly. That is as maybe. The BOJ may have been slow out of the blocks, but it sure made up for lost time. Today, the debt (government) to GDP ratio stands at over 250%. This is mainly due to the Bank buying up its own treasury bonds (45% of the total) and corporate shares (15% of the total). Many reasons have been given for this except the one that matters. The real rate of profit is at rock bottom.

All profit data in Japan can be accessed using the link below and clicking on the current Excel document for the quarter ended March. All figures are taken from the sheet marked M1. The rate of return based on operating profits for all industries divided by fixed assets works out at 2.17%. The more complex rate of return based on dividing operating profits by fixed assets plus inventories yields 1.83%. The actual rate of profit based on dividing operating profits by fixed and circulating capital yields 1.75%. Even the most favourable measure, dividing operating profits by net assets still yields a miserable 2.6%. [https://www.mof.go.jp/english/pri/reference/ssc/results\\_index.htm](https://www.mof.go.jp/english/pri/reference/ssc/results_index.htm)

The reason is not hard to find. The ratio of constant capital to output is 295% and the value composition of capital which includes turnover is over 1,400%. The result of this paltry rate of profit is that gross investment, including R&D is 8% of Value Added and if we adjust for depreciation this falls to 5.9% This fall in investment has had two effects. Industrial production is only 2.8% above the 2015 figure while cash on hand has soared to \$3.7 trillion.

Does the same fate face the USA? Currently the rate of profit in the USA is around 5.8% (first quarter 2019). US inflation is 1.5% higher, thus the adjusted rate is 4.3% versus 1.8% for Japan. It is still higher in the USA as would befit the world monopoliser of profits, but is trending down. It has fallen 25% since 2014 its high point this century. Adjusting for the cost of capital difference of 1.9% there is only 0.6% difference between the two countries. In the USA the difference between AAA interest rates and the rate of profit adjusted for inflation is 1.4%, and, for Japan it is 0.8%.

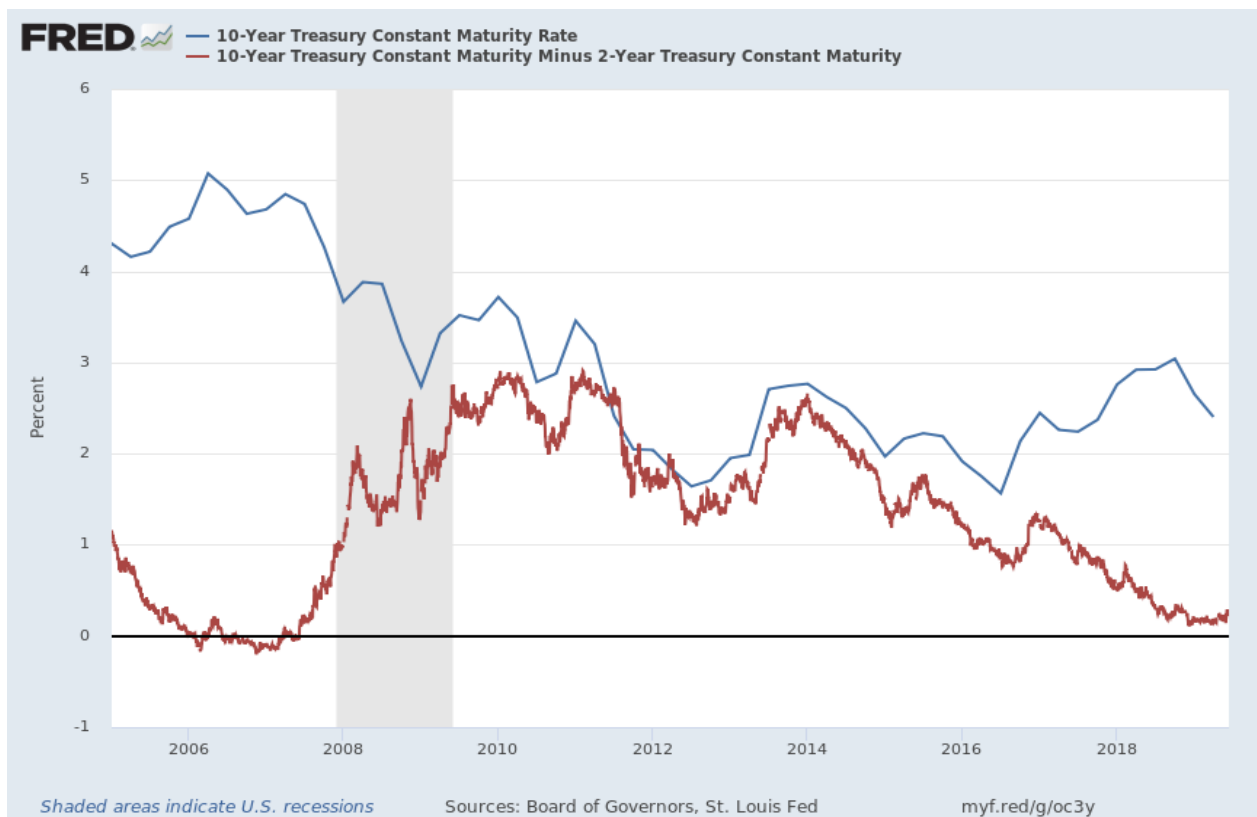
### **Does this mean a credit emergency will be avoided?**

It is clear that central banks are on high alert and that they have refined their hair triggers. But in the end the rate of profit is key. No matter how low interest rates fall they still have to be paid and can only be paid if profits are made. If the volume of interest payments exceeds the volume of profits in a corporation or a sector of the economy, then the issue of solvency arises. More specifically, if interest payments exceed corporate cash flow which includes depreciation, then that corporation is insolvent. And even if it is not insolvent, it is in no position to continue investing for reproduction which has a knock-on effect throughout the economy where it acts as a multiplier.

The one sector that is insolvent, is the tight oil and gas sector in the USA. At current prices it is likely to be experiencing negative cash flow. It is also home to a preponderance of high yield and leveraged loans. It is emblematic of an economy where corporate debt has soared to nearly \$10 trillion and where much of the recent surge of borrowings has been BBB rated, the lowest investment grade of bonds.

The ongoing inversion of interest rates between the 10 year and 3-month rate is concerning the markets in the USA. It should. The distortions created by the unwinding of QE, now stopped, no longer affect the ratios. As the graph below shows, the more important 10-year to 2-year yields have yet to invert. There are two graphs superimposed. The blue graph is the actual interest rate on 10-year

bonds. Over the last year interest rates have fallen by 1.1% from 3.2% to 2.1% currently. When the 10-year yield fell in 2007, the inversion ended and the difference in rates went positive reaching 2%. But look now. Despite the fall in the 10-year yield, the difference remains close to 0%. It is flatlining around 0.2%. There has been no significant upward movement.



Thus, the absence of inversion in this case is not as important as the peculiar behaviour between the two graphs, where the current fall in the 10-year yield is not raising the differential with the two-year yield as it did at the end of 2007. Clearly the bond markets have a view on the economy which is different to that of the stock market. To steal a line from Keynes, it appears that the intoxicated animal spirits still prevails on Wall Street. The question which is posed is which view will prevail? Will it be the bond market or the stock market?

If it is the former, there will be a sudden contraction, if the latter prevails it will be a slower contraction. If both coincide on the downside there will be a credit emergency, a rush for the exits. A resolution either way is imminent. All the talk in the financial blogosphere concerns itself with whether recession can be avoided. Certainly, the mood is darkening, despite the recent data in the States which has been inflated, deliberately or otherwise, by a misreading of prices.

The G20 meeting will be interesting. The USA is stirring in Hong Kong. It should be scared of what it wishes for. The Crash of 2019 will make the streets in the USA itself unsafe for capital. The workers may have ended up paying for 2008, but they are unlikely to be fooled a second time.

Brian Green, June 2019.