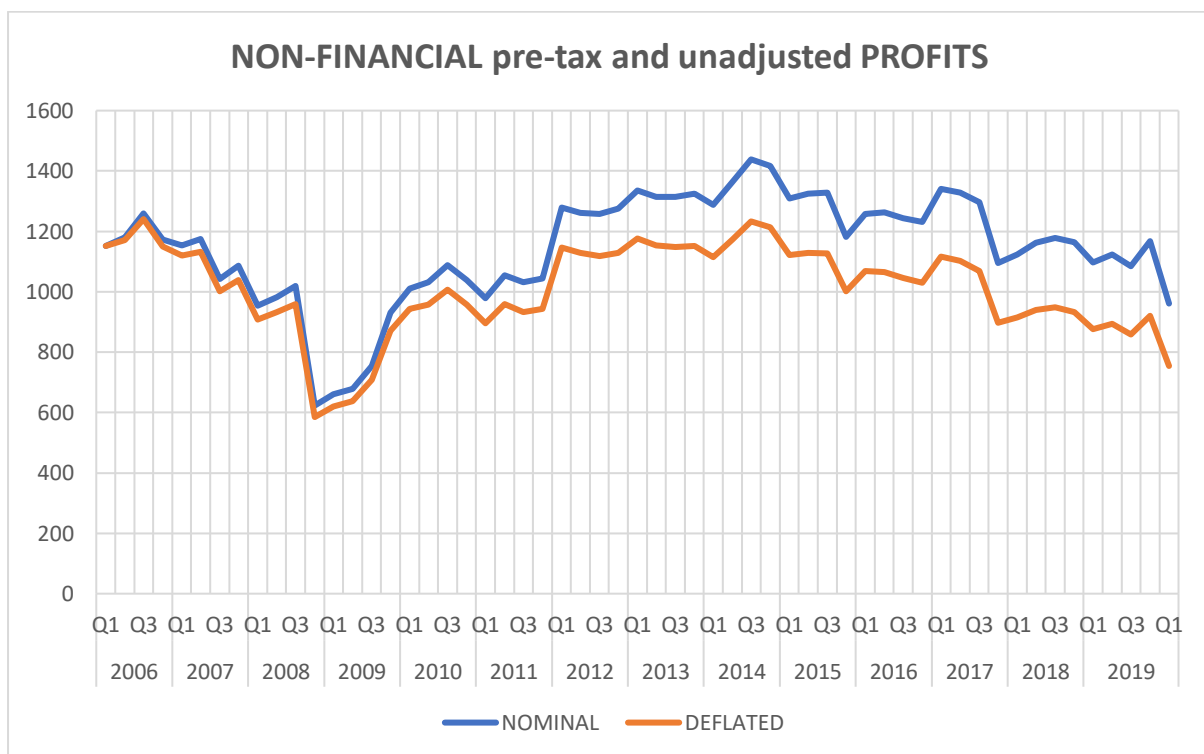


STOCK MARKETS INOCULATED, BUT ECONOMY REMAINS VULNERABLE DUE TO UNDERLYING CONDITION - LOW PROFITABILITY.

In many ways, we are now in the eye of the hurricane or cyclone. That eerie calm with clear blue skies. But as any meteorologist knows, the tail winds that follow this calm are more powerful and destructive than the leading winds which have recently passed.

Corporate profits for the USA have just been released. Unadjusted pre-tax profits (line 37 NIPA Table 1.14) fell 12.5% annually and 17.5% quarter on quarter. They are expected to fall by 36% in Q2 according to FactSet but I assume a slightly more conservative outlook of 30%. Graph 1 applies the data released by the BEA on the 28th May 2020.

Graph 1.

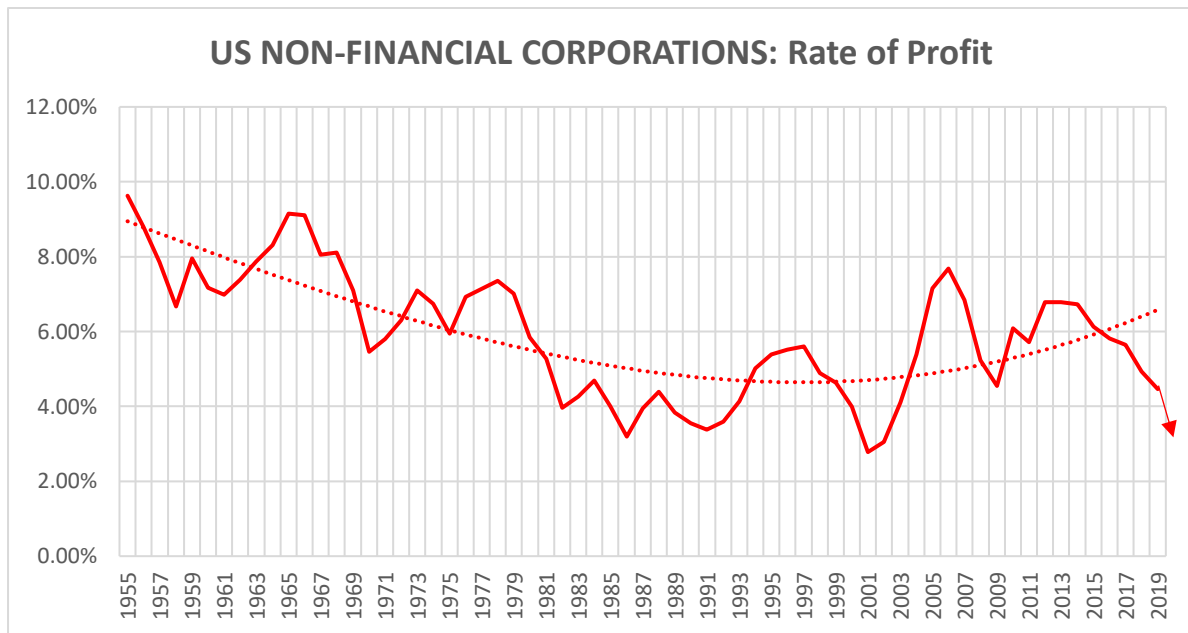


(Source: NIPA Table 1.14 for profit and 1.1.4 for prices)

Inflation adjusted profits have been added in. As of Q1 2020 the mass of profits has not fallen below the trough found in Q4 2008. It is likely however, that the fall in Q2 will lead to a trough as low as or below that found in 2008, but in an economy where GDP is somewhat larger.

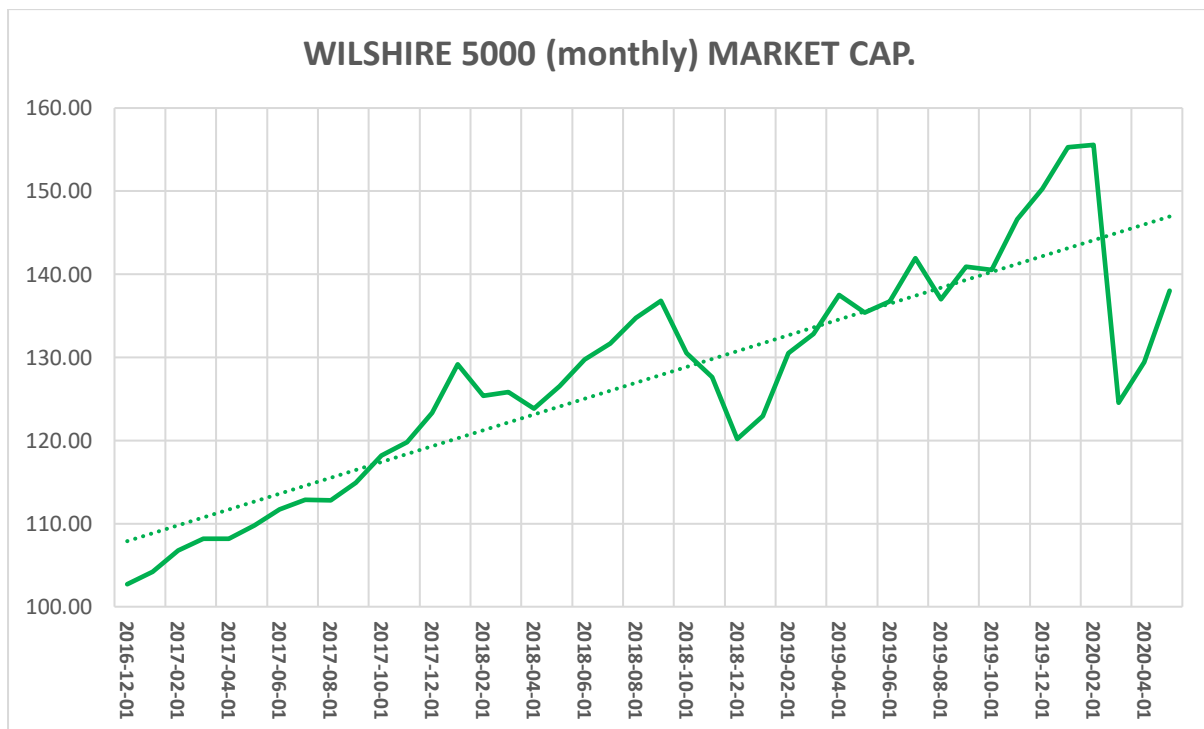
The same cannot be said for the rate of profit. Between 2008 and 2020 capital, both fixed and circulating has grown resulting in a rate of profit that is sharply lower, trending below that found in 2008. In fact, the expected rate of profit in Q2 will be the joint lowest rate of profit since the War, alongside the rate of profit found in 2001. The arrow approximates the fall in profitability to 2.9% based on a 5% contraction in total capital and a 30% fall in profits.

Graph 2.



The markets however are ignoring this plunge in profitability. They mimic the confusion caused by hypoxia which is associated with low levels of profit. Graph 3, expresses this confusion, showing by how much the markets have recovered since being hammered by the leading winds of the pandemic storm earlier this year.

Graph 3.

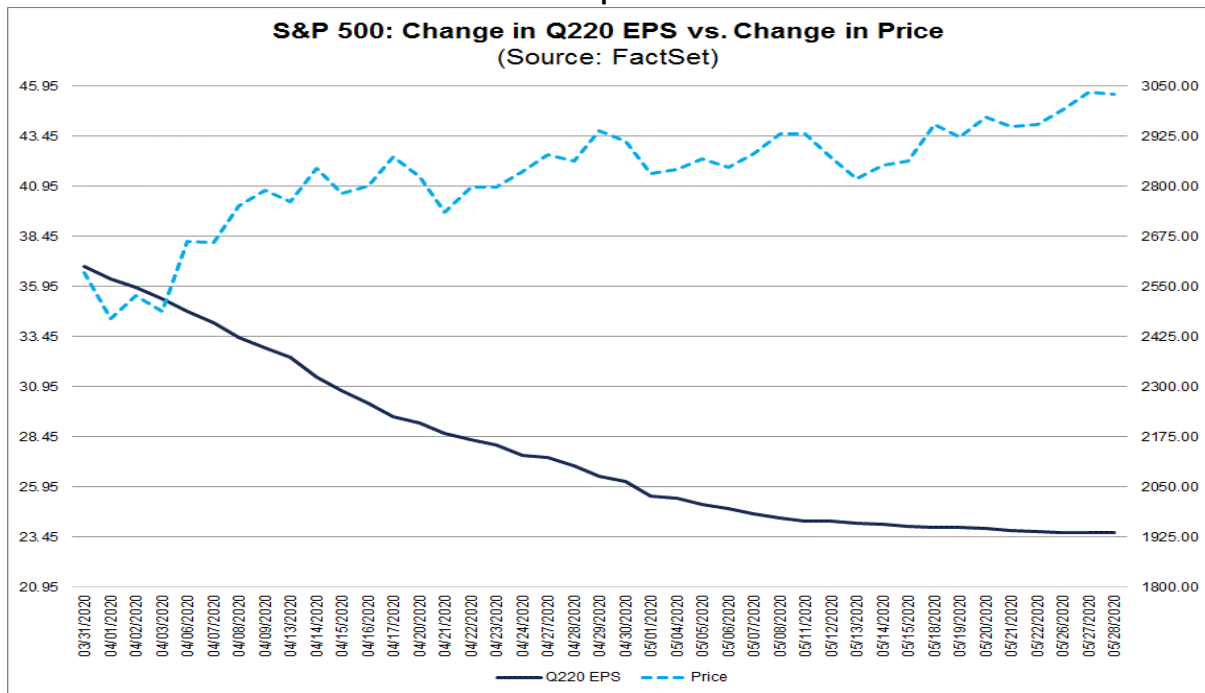


(Source: FRED Table WILL5000INDFC)

At the close on Friday, the index was at 144.18 or above the average for most of 2019, that is before the FED threw money at the markets in late September leading to an extraordinary bounce.

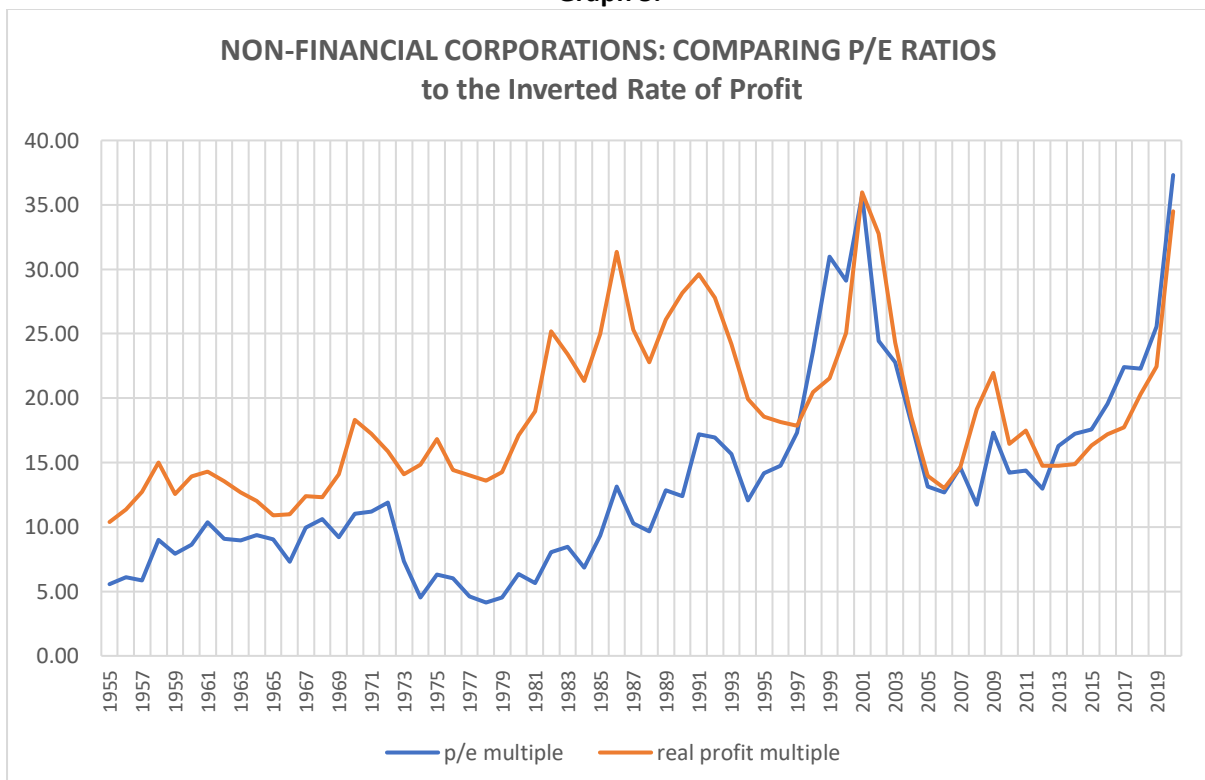
The next two graphs compare the P/E index with the expected movement in profits. The FactSet Graph details the fall in the outlook for Q2 profits, now put at -36%, against the 20% rise in S&P 500 share prices. The two graphs form the jaws of a bear trap, literally.

Graph 4.



https://insight.factset.com/record-high-cuts-to-sp-500-eps-estimates-for-q2-2020-to-date?_hsmi=88707921&_hsenc=p2ANqtz-ig1in2Wr5RsCmNYs6UDXluUjN_eJdIddevy89Mk9Zbg6cxMRI1E6OG04EIDmpGRczk7mCVO4r8IKdey0SD7h_IJSPXw

Graph 5.



Focusing on the all important Graph 5, we note that the fictitious multiple (P/E ratio or market cap to profit ratio) has risen above that found at the height of the dotcom bubble, which was the highest multiple in the history of share prices, exceeding that of 1929. We also note that it continues to outrun the real multiple (fixed and circulating capital divided by profit). Thus, we are witnessing the biggest bubble in history, thanks to the inoculations handed out to the investors and bankers on Wall Street. Actually, a lot of the new investments on Wall Street have come from the pockets of ordinary retail punters fired up by their X boxes or Nintendo consoles while in lockdown. The inevitable blood bath will drown those who can least afford it and who will not be covered by any rescues.

Turning to the Dotcom bubble collapse in 2001, the Nasdaq index, Casino Royale, fell 67% as the graph below shows. It took 16 years for the Nasdaq to retrace its dotcom high.

Graph 6.



The markets remain highly vulnerable. Having recovered from the earlier and underestimated shock from shut down; they are now counting their returns before they are hatched or shall we way emerge from their petri dishes. The grabbing onto snippets of good news while ignoring the bad, is eye watering. The gullibility exceptional. Take *Remdesivir* developed by Gilead Sciences. Newspaper hype sent share prices soaring. The media release claimed it reduced intensive care stays by 4 days. Except that Gilead was coy about releasing their data. When they did it showed the drug helped only a small subset of patients on oxygen therapy. Previous negative studies, WHO & China, were dismissed. And then there is Moderna, which is a true dotcom company, having yet to produce a product for sale. No sooner had it reported favourable first stage vaccine results, sending its share price soaring, than insider shareholders were seen running for the exits selling shares. According to the NASDAQ link below, the number of shares sold recently by insiders increased by 250% compared to the previous 9 months. <https://www.nasdaq.com/market-activity/stocks/mrna/insider-activity>

The opposite is the case with hydroxychloroquine. This unprofitable product has taken a beating in the medical press, most recently in the Lancet, which led to a number of major trials being discontinued before results were in. On scrutiny, the data supporting the conclusions of this rushed review, which excluded zinc, were found to be deeply flawed. Hospitals were mislabelled, dates inconsistent, and data sources were unofficial. This slanted review of tests was better suited to a Marvel comic, than the Lancet. This is the flip side of the biased hype for the highly profitable Remdesivir. It shows how corrupt Big Pharma, which puts profits before patients, really is.

Quarter 2 GDP.

The Atlanta Fed also brought out its projection for Q2 at the end of last week. This real time analysis now anticipates the economy having contracted at an annual rate of 51.2% over the first two months of this quarter. Clearly this will not be the final figure as the data for June is not in, and with lockdowns unwinding in most US states there will be some recovery in the final month of the quarter, which is why the FED views it's figures as a "running estimate".

Graph 7.

"The GDPNow model estimate for real GDP growth (seasonally adjusted annual rate) in the second quarter of 2020 is **-51.2 percent** on May 29, down from -40.4 percent on May 28. After this morning's Advance Economic Indicators report from the U.S. Census Bureau and personal income and outlays release from the U.S. Bureau of Economic Analysis, the nowcast of second-quarter real personal consumption expenditures growth decreased from -43.3 percent to -56.5 percent..."

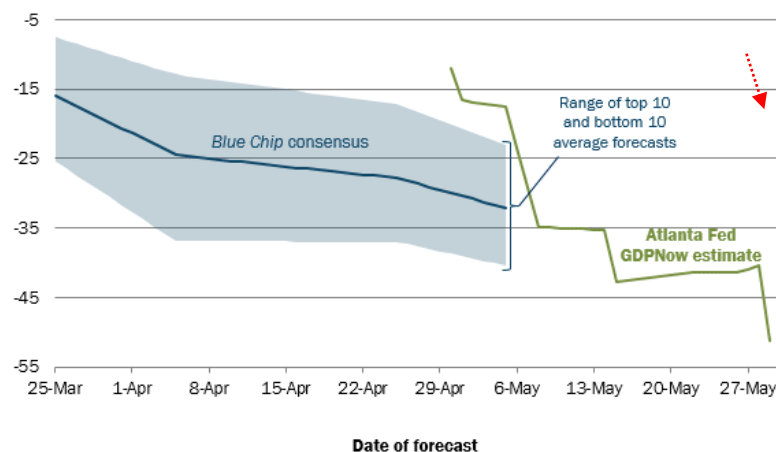


GDPNow™

GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter. There are no subjective adjustments made to GDPNow—the estimate is based solely on the mathematical results of the model.

In particular, **it does not capture the impact of COVID-19** beyond its impact on GDP source data and relevant economic reports that have already been released. It does not anticipate the impact of COVID-19 on forthcoming economic reports beyond the standard internal dynamics of the model.

Evolution of Atlanta Fed GDPNow real GDP estimate for 2020: Q2
Quarterly percent change (SAAR)



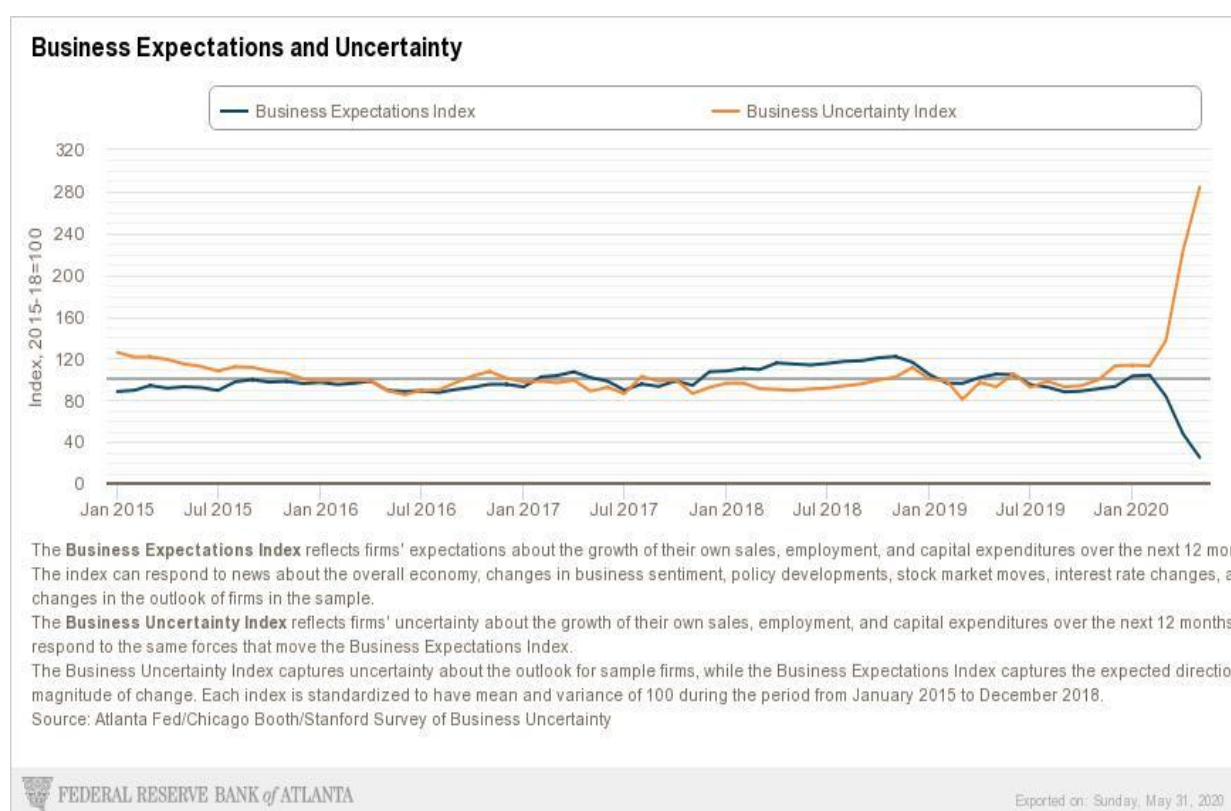
Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts

Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the Blue Chip survey.

<https://www.frbatlanta.org/cqer/research/gdpnow>

It is not necessary to go into individual surveys as they fold up into the above running estimate of current US GDP. One survey however is worthy of mention – *US: Survey of Business Uncertainty*. This index attempts to capture the outlook for business in the US. In May that index shot up from 115 prior to the pandemic to 284.4 in May. It is important to note that the *Uncertainty* index only posits optimism when it sits below 100. Until the end of last year, it sat at 90. Thus, even before the pandemic, the *Uncertainty* Index read of 115, showed business trending towards pessimism.

Graph 8.



<https://www.frbatlanta.org/research/surveys/business-uncertainty>

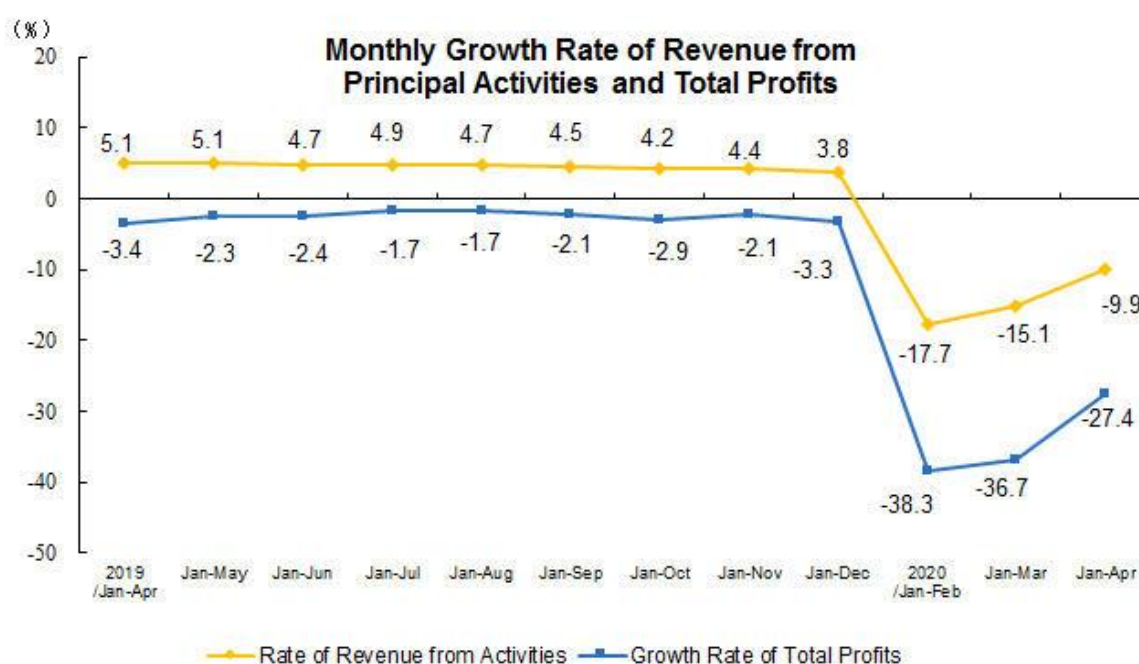
China and its Congress.

The Chinese economy contracted 6.8% in line with all the other major economies. Only India bucked the trend because its lockdown occurred only at the end of March. As predicted the lockdowns in its major export markets held back the recovery in China. The WTO estimates that global trade in industrial products this year is likely to contract by around 20% this year. This will impact China adversely as it is the world's biggest exporter of industrial goods. Furthermore, this trend will be exacerbated by the intention on the part of the G7 to relocate supply chains, currently centred on China, away from China.

As in the USA, the pandemic trashed industrial profits. Profits for the first four months fell by 27.4% and in April by 9.9% year on year. It is important to note that while revenue was rising throughout 2019, profits were falling (Graph 9 below). Thus, profit margins were being squeezed even before the pandemic.

Over the first four months of the year, the annualised complex rate of return fell by half to 3.2%. Contributing to this fall, the annual rate of turnover fell from 6 to 4.45 (21.7 days for inventory turnover and 59.8 days for credit to clear, cumulatively an increase of 15 days in the period of circulation. All data in the link below Graph 9.)

Graph 9.



www.stats.gov.cn/english/PressRelease/202005/t20200528_1749645.html

The delayed National People's (not Workers) Congress finally took place at the end of May. It is worth reading Premier Li Keqiang keynote speech to the National People's Congress. It is titled *Report on the Work of the Government*. In this audit there is a recognition that; "At present and for some time to come, China will face challenges like never before." In response, the Congress approved a 6.6% increase in military spending, significant, but not a declaration of an arms race. Yet! http://english.www.gov.cn/premier/news/202005/30/content_WS5ed197f3c6d0b3f0e94990da.html

Of all the sections in his speech, the fifth is the most consequential. Its heading reads: *Implementing the strategy of expanding domestic demand and promoting accelerated transformation of the economic growth model.* He emphasises less reliance on exports and more reliance on building up the Chinese market to absorb production. It was always China's goal of using the local market to build Chinese champions capable of entering the world market. Despite being the world's largest industrial economy, uniquely China has relatively few world-scale and world-class corporations. The breakdown in globalism will force China to remain dependent for longer on its internal market to develop its technological standards, and when it does cement these standards, its champions will enter a world economy now split between China and the USA, with Europe in the middle.

This year China will be formulating its 14th Five-Year Plan, and without doubt, the goals set out in this speech will inform the parameters of this future plan. Crucially, this Plan will be focusing on reducing China's precarious dependency on foreign technology. It will build on Xi's perspective, first articulated in 2018 to build Chinese self-sufficiency. "Self-sufficiency means China must be able to (1) develop technology without overreliance on the west and (2) radiate influence on allies via Belt and Road Initiative (BRI)".

There are two embarrassing elements in and around the speech. The first is to listen to a fawning bureaucrat paying lip service to his boss, not the rate of profit, but President Xi himself. The second is the non-fawning element, the focus on making money. One of the key sections in the speech is devoted to strengthening the private sector and encouraging inward investment while protecting it. In Michael Robert's website the <https://thenextrecession.wordpress.com/> there are to be found, many commentators who still view China as being essentially socialist. Strip out the crap in this speech about the leading role of the party inspired by Xi, and what you have is a prescription for building capitalism and ensuring money makes money.

China is a capitalist country and an incipient imperialist one at that seeking to radiate influence. While the BRI is a political attempt to break US encirclement of China, its long-term goal is to cement Chinese economic hegemony in the region. The old-fashioned way of viewing imperialism, in terms of military invasions, has been replaced by financial entrapment. China is seeking to create a web of financial dependency covering South East Asia, the Middle East and Africa.

Conclusion.

The pandemic began as a fast-developing storm that caught many unprepared. The descent into depression caused by the lockdowns was the fastest ever in the history of capitalism. Since then the path and progress of the storm has slowed down, thanks to the drag caused by central bank and treasury based financial injections. These will raise deficits in most major economies to 20% this year and the total stimuli may amount to \$25 trillion worldwide this year.

These stimuli cannot compensate for the 25 to 30% loss in value and surplus value during the first half of the year. Money cannot create value only circulate it, and when it seeks to substitute for it, only debt results. The question is whether this debt will be monetised, will it be kept on the books and rolled over or will workers be forced to pay it back through another round of savage cuts.

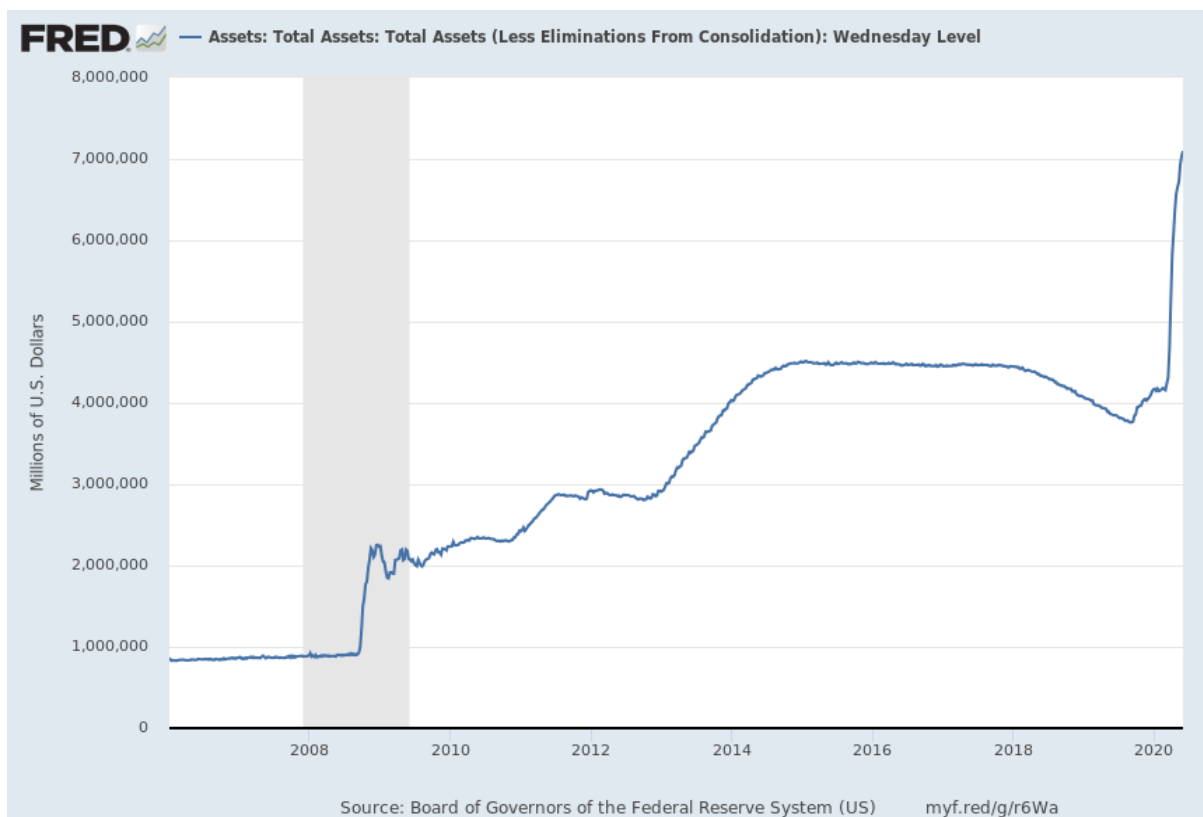
The loss in value is a real irreplaceable loss. Even if the economy returns to normal output later in the year, that loss will not be made up. So, while central banks can improve corporate liquidity, they cannot repair insolvency. Throwing money at unprofitable corporations means throwing good money after bad. They can delay but not stop bankruptcies.

The scale of the tail winds will be determined by the following. How quickly industries can get back into production (which begs the question of whether there will be a rebound in infections)? Secondly which industries will be permanently reduced? What share of the economy do these industries represent? And connected to this, what is the amount of debt that will need to be written off?

It is likely that it will take up to July for economies to re-open, provided there are no secondary waves of infections. A back of the envelope examination of the economy suggests that up to \$500 billion will not reopen until a vaccine is developed if ever. This covers the Oil & Gas industry, Manufacturing, Retail, Travel, Entertainment and the biggest chunk, Hospitality (Accommodation and food services). This represents 2.5% of the economy before the multiplier effect kicks in as upstream industries providing inputs are hit as well. If a figure of 4% is agreed, then the annual loss of GDP this year could reach 20%. That is a Category 5 trailing wind.

As yet there is no financial crisis. True in the first few weeks such a crisis was narrowly averted and at huge cost to the central banks and hence taxpayers. The scale of this intervention is shown in the final graph below. The total amount pumped into the economy over 7 years between 2008 and 2015, nearly \$4.5 trillion, was pumped into the economy in just 7 months this time around. And it is not over by any means.

Graph 10.



The FED has got its mojo back according to the markets. But these financial stimuli are a crutch. They treat symptoms not underlying causes which remains the chronic lack of profitability and its reflex, productive investment. And when the time comes and this crutch is not enough, it will have to be replaced by a wheelchair, and finally when that is not enough by a stretcher. Which makes us think of coffins replacing stretchers and Marx's characterisation of workers as "the future grave diggers for capitalism".

In parallel the issue of interest rates looms large as central banks around the world seek to finance their burgeoning deficits. According to the Bank of International Settlements, Bulletin 18 issued on the 20th May, Emerging Market bond yields have already spike by 1%, or the same order post-Lehman, except that this time round, it happened more quickly. <https://www.bis.org/publ/bisbull18.htm>

It was always likely that EME yields would rise first as many of them are dollar dependent, but it cannot be ruled out that the scramble for loans will not lead to a spike in interest rates all over the world. Currently, key international rates remain static. It must be remembered that negative interest is only acceptable to lenders because of the capital gains to be made by escalating negative rates. Should these rates reverse and turn positive due to the extraordinary demand for loans, then a bloodbath will ensue in the bond markets.

On balance, in the words of Central Bankers, the risks are on the downside. The trailing winds have not subsided. When the reality dawns of mass unemployment, of whole swathes of industry lost, and a cascade of debt delinquencies, it is unlikely that fictitious capital will remain in its current state of mindful levitation.

Additionally, the political consequences of this pandemic and its differential impact on society are now materialising. The race riots tearing many cities in the USA apart is a sign of things to come. India is

another example. It appears that the most brittle societies are the ones led by populist leaders, Trump, Johnson, Bolsonaro, Modi and the like. Elected out of frustration, they have increased societies frustration with their greedy incompetence.

This applies to Britain in particular. The 20% plunge in Johnson's approval rating to zero and beyond augurs badly for this government. Even its large parliamentary majority is a liability encouraging street protests. For a government to lose its credibility during the biggest crisis since the War, is to stoke the flames of rebellion once the crisis has passed and the fear has subsided.

This government limps from crisis to crisis. The latest fiasco is its "world beating track and trace system". Turning on our universal translator, "World beating" is Tory code for starting from scratch so our business mates who have never set up such a system, can make loads of money trying to develop it. The government would have been wiser to have sent a NHS official to Germany, or Singapore, or Taiwan to buy a tried and tested system off the shelf for next to nothing. Instead we will be saddled with a system better described as "crap and waste" rather than "track and trace". Johnson has been shown to be nothing more than the glove puppet of Dominique Gove, who drove many miles to prove he was fit to continue pillaging the state. In their blood-soaked hands, the current Covid slogan should read: **"Be Brexit Alert, Control Society and Protect the Virus."**

Our task is to ensure that in time, anger replaces fear, and that these political villains answer for the many needless deaths they caused, by putting Provides before Workers.

Brian Green 31st May 2020.