John Williams'
Shadow Government Statistics
Analysis Behind and Beyond Government Economic Reporting

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This is the third section of this Issue.
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REPORTING PERSPECTIVE

The Big Three Market Movers

Most underlying economic fundamentals have continued to deteriorate in recent reporting, yet, key headline statistics -- specifically employment, GDP and elements of the CPI -- increasingly have shown market-pacifying results, which is highly suggestive of political/financial-market oriented manipulation.

The surging second-quarter GDP growth, better-than-expected July payroll numbers, and "core" inflation that somehow keeps dodging the permeating effects of higher oil prices, are numbers that only a mother (Hank Paulson or Ben Bernanke) could love and believe in.

Messrs. Bernanke and Paulson need a stable U.S. currency, particularly under the circumstances of the increasingly vulnerable and fragile bailout of the domestic banking/financial system. The Administration's political needs remain great, and with financial circumstances threatening national security, almost anything remains possible in the arena of data and market manipulations. Data manipulation remains an extremely inexpensive and effective policy tool. As discussed in the Opening Comments, the tool has been used with significant, albeit short-lived impact in support of the greenback.

Absent manipulations, and against market expectations that have moved once again far away from reality, most near-term economic reporting should tend to surprise the markets on the downside, while most inflation reporting should surprise expectations on the upside. Watch out, though, for the key headline numbers, at least until after the November election.

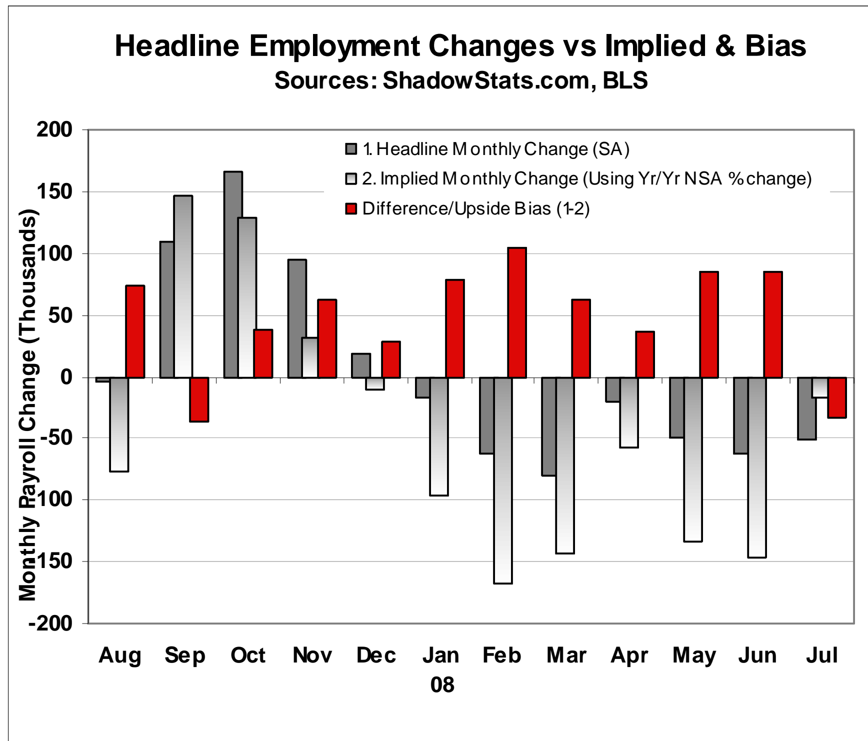
Employment/Unemployment -- As discussed in the August 1st *Flash Update* and graphed in the Opening Comments, signs of a purported economic boom did not show up in the July employment report. In particular, year-to-year change in the July 2008 payrolls showed a second

month of a deepening contraction in the unadjusted numbers, an event never seen outside of a recession. The reported seventh consecutive decline in monthly payrolls also continued to show a recession in place, as likely will be recognized eventually (post-election) by the National Bureau of Economic Research (NBER), official arbiter of recessions. The continued deterioration in the unemployment rate -- particularly the surge in the broadest official unemployment measure (U.6) -- also signaled intensifying business difficulties.

Payroll Survey. The Bureau of Labor Statistics (BLS) reported a statistically-insignificant, seasonally-adjusted jobs loss of 51,000 (down 25,000 net of revisions) +/- 129,000 for July, following a revised 51,000 (previously 62,000) jobs loss in June. Annual change (unadjusted) in total nonfarm payrolls was negative, down 0.13% in July versus a revised 0.07% (was 0.12%) decline in June (see the graph and discussion in the Opening Comments section). The seasonally-adjusted series also turned negative year-to-year, down 0.05% in July, versus a 0.14% gain in June.

Concurrent Seasonal Factor Bias. The pattern of impossible biases (see the Reporting/Market Focus in the prior *SGS Newsletter*) being built into the headline payroll employment changes reversed with the July reporting. Instead of the headline jobs loss of 51,000, consistent application of seasonal-adjustment factors -- net of what we are calling the concurrent seasonal adjustment bias -- would have shown a less-severe monthly jobs loss of about 17,000.

The reversal of the pattern seen previously in 11 out of 12 months of reporting was subsequent to a request from within the BLS for my calculations (the worksheet is available to anyone upon request). We have not received nor have we requested a comment on these numbers from the BLS.



Nonetheless, unusual revision patterns still were seen in the July report, where the unadjusted June payroll number was revised upward by 70,000, but that only translated into a 26,000 upward revision to the adjusted numbers. While such raised the level of the previously reported payroll employment, it resulted in a relatively weaker base against which the June to July adjusted change was calculated.

The deterioration in July's employment environment continued in line with, but still shy of reality, per trends indicated by the better-quality employment-environment indicators: June help-wanted advertising bottom-bounced near the prior month's historic low; new claims for unemployment insurance continued to surge sharply in terms of annual growth; and a recession-level employment reading was seen in both the June manufacturing and nonmanufacturing purchasing managers survey (leading indicators of July employment). The just-released July surveys showed the manufacturing employment component moving into positive territory, but the nonmanufacturing employment measure held in contraction territory. In combination, these factors suggest that an ongoing jobs loss running in excess of 100,000 jobs per month would be closer to reality than the officially-reported changes (see the respective sections).

Since the employment and unemployment indicators tend to be coincident markers of broad economic activity, weaknesses in these numbers are signaling an ongoing recession in place.

Birth-Death/Bias Factor Adjustment. Another element that usually adds upside pressure to the monthly payroll numbers but was muted in July was the monthly bias factor (birth-death model). Never designed to handle the downside pressures from a recession, the model added a 4,000 jobs bias to July 2008 (versus the prior July's 3,000 upside bias), following a net upside bias of 177,000 jobs in June 2008.

Household Survey. The usually statistically-sounder household survey, which counts the number of people with jobs, as opposed to the payroll survey that counts the number of jobs (including multiple job holders), showed household employment fell by 72,000 in July, following a 155,000 decline in June.

The July 2008 seasonally-adjusted U.3 unemployment rate showed a statistically-insignificant increase to 5.68% +/- 0.23% from 5.50% in June. Unadjusted, U.3 increased to 6.0% in July, versus 5.7% in June. The broader U.6 unemployment rate jumped to an adjusted 10.3% (10.8% unadjusted) in July versus 9.9% (10.3% unadjusted) in June. Refigured for the bulk of the "discouraged workers" defined away during the Clinton Administration, actual unemployment, as estimated by the SGS-Alternate Unemployment measure, rose to 14.3% in July, from 13.9% in June (see the Alternate Realities section in the Opening Comments).

Next Release (September 5): Based on continuing deterioration in underlying economic activity, the August payroll survey should show deepening month-to-month and annual contractions, while the household survey should show a further rise in the unemployment rate (barring political massaging). The unfortunate reality remains, however, that these numbers can be brought in at whatever level is desired by the Administration or the Federal Reserve, and risk of political distortion remains extremely high.

Gross Domestic Product (GDP) -- This issue's Reporting/Market Focus examines the recently published annual revisions to the national income accounts, which showed -- as has become traditional -- that previously reported GDP growth was not quite as strong as initially indicated. In fact, given the new reporting patterns, the current recession tentatively has started to appear as having begun in fourth-quarter 2006, but recognition of such remains at least a year away -- probably longer -- dependent on the eventual

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grand-scale benchmark revision to the GDP data that remains long overdue.

As to the current reporting, only the political hacks in the Administration and the spinmeisters on Wall Street could profess to believe the surging GDP activity claimed for second-quarter 2008. As discussed in the July 31st *Flash Update,* despite sharp quarterly contractions in employment, industrial production, new orders, real retail sales and residential construction, among other series, the second-quarter 2008 GDP was reported as booming (net of inventory reductions, the inflation-adjusted economy expanded at an above-average annualized 3.9% rate).

With fourth-quarter 2007 revised into a 0.17% contraction (previously a gain of 0.58%), the official story now likely will go along the lines that the economy dipped a little in the fourth quarter -- not enough to be called a recession -- and has been in recovery ever since. Such is an absurdity, given the reporting of better quality surveys discussed in the Opening Comments and extremely strong anecdotal evidence to the contrary, but the reporting will enable the pushing off of any recession recognition until after November.

Key to the unbelievable report was the use of artificially low inflation in deflating the GDP. In theory, the GDP is first estimated in nominal, or not-inflation-adjusted, terms, and then deflated using the GDP's implicit price deflator (IPD). The IPD inflation was at an incredibly-low annualized 1.11% for the quarter, down from 2.56% in the first quarter, and at a 10-year *low* (lowest since second-quarter 1998). The lower the IPD used, the stronger will be the inflation-adjusted growth. In contrast, on a parallel calculation basis, CPI inflation was 5.04%. Outside of 6.34% in third-quarter 2005, that was a 17-year *high* quarterly inflation rate (highest since 6.97% in fourth-quarter 1990). There is enough room in the price-adjustment gimmicks for there to have been a meaningful contraction in second-quarter GDP.

In the context of the mildly weaker historical GDP -- an overall downward revision of 0.5% spread over three years -- the Bureau of Economic Analysis (BEA) reported that the "advance" estimate of annualized, seasonally-adjusted real (inflation-adjusted) growth rate for the second-quarter GDP was 1.89% (down 0.02% net of revisions) +/- 3%, up from a revised 0.87% (previously 0.96%) in the first quarter. Year-to-year annual change in second-quarter GDP fell to 1.82% from a revised 2.54% (previously 2.55%) in the first quarter.

In inflation-adjusted dollars, the reported annualized improvement in the trade deficit ($66.8 billion) -- though highly questionable -- more than accounted for the reported annualized quarterly growth of $54.6 billion to bring total real GDP to $11,700.6 billion. Such, in turn, largely was offset by a net liquidation of business inventories ($52.0). That means that the rest of the economy: personal consumption (plus $31.4 billion), fixed investment (minus $10.8 billion), and government (plus $17.2 billion), accounted for $39.8 billion (or $37.8 billion) of the growth -- if only the numbers added up. Due to the quirks of GDP deflation methodology, the underlying GDP categories total $190.4 billion more (a "residual") than the officially-reported GDP.

The BEA's GDP-like measures for second-quarter 2008, including Gross National Product (GNP), where GDP is GNP net of trade in factor income (interest and dividend payments), and Gross Domestic Income (GDI), which is the theoretical income-side equivalent to the GDP's consumption-side measure, were not estimated in the "advance" reporting, since the BEA did not have enough information to guesstimate them meaningfully (the BEA also did not have enough information to guesstimate the GDP). The results of the related benchmark revisions, however, are examined in the Reporting/Market Focus.

Adjusting for methodological distortions and gimmicks built into GDP reporting over time, the SGS-Alternate GDP measure suggests that

economic reality was much weaker than officially reported. A second-quarter year-to-year contraction of roughly 2.9% would have been more in line with underlying fundamentals, past methodologies and the ongoing recession (see the graph in the Alternate Realities section of the Opening Comments). Such reflects some bottom-bouncing with the annual contraction somewhat greater than the SGS-Alternate GDP first-quarter estimate of a 2.7% annual decline.

General background note: Although the GDP report is the government's broadest estimate of U.S. economic activity, it is also the least meaningful and most heavily massaged of all major government economic series. Published by the BEA, it primarily has become a tool for economic propaganda.

Next Release (August 28): The "preliminary" estimate revision of second-quarter GDP growth could see significant upward revision, thanks to the "improvement" in the June trade deficit and the May revision, reported subsequent to the "advance" estimate of GDP growth. The nature of the current economic and systemic financial crises argues for continued fluff and for positive GDP reporting until after the November election.

Consumer Price Index (CPI) -- As discussed in the July 16th *Flash Update,* consumer inflation surged to a 17-year high annual rate of 5.0% in June, as measured by the CPI-U all-urban-consumers measure. Even worse, for the narrower CPI-W -- targeted at the wage-earners category where gasoline takes a bigger proportionate bite out of spending -- annual inflation jumped to 5.6%. The measure used for making the annual cost of living adjustments to Social Security payments is the CPI-W, and the 2009 adjustment that will be based on the July to September 2008 period now is a good bet to top 5%, more than double last year's 2.3% adjustment for 2008.

Where annual SGS-Alternate M3 growth has stalled at around 15.4% in July, such still is highly inflationary, and likely new liquidity moves by the Fed/Treasury should spike annual growth further in the months ahead. In conjunction with high oil prices (still above $100 per barrel) and a volatile dollar that still is down year-to-year and likely headed much lower, the rapid money expansion still suggests double-digit inflation -- as officially reported in the CPI -- into early 2009.

CPI-U. The Bureau of Labor Statistics (BLS) reported that the seasonally-adjusted June CPI-U (I.6) gained 1.06% (1.01% unadjusted) +/- 0.12% for the month, versus the 0.65% (0.84% unadjusted) gain in May. Year-to-year or annual inflation in June jumped to 5.02% from 4.18% in May. Annual inflation will continue its upturn in July 2008 reporting, dependent on the seasonally-adjusted monthly gain exceeding the 0.22% monthly increase seen in July 2007, which appears highly likely. The difference would directly add to or subtract from June's annual inflation rate of 5.02%.

The adjusted monthly inflation gain reflected negligible catch-up from the underreporting of energy-related inflation in recent months; such should intensify some in the next report. The lack of significant pick-up in the gimmicked concept of "core" inflation remains beyond belief and is addressed in the Opening Comments.

C-CPI-U. Annual inflation for the Chain Weighted CPI-U (I.5) -- the fully substitution-based series that increasingly gets touted by CPI opponents and inflation apologists as the replacement for the CPI-U -- jumped to 4.24% in June, up from 3.62% in May.

Alternate Consumer Inflation Measures. Adjusted to pre-Clinton (1990) methodology (I.7), annual CPI growth rose to roughly 8.3% in June from 7.5% in May, while the SGS-Alternate Consumer Inflation Measure (I.8), which reverses gimmicked changes to official CPI reporting methodologies back to 1980, rose to a 27-year high of roughly 12.6% in June, up from 11.8% in May. The alternate numbers are not adjusted for any near-term manipulations of the data.

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The eight levels of annual inflation, I.1 to I.8, are detailed in the table in the Alternate Realities section, along with the graph of SGS-Alternate Consumer Inflation.

Next Release (August 14): Annual July CPI inflation should rise sharply, again, based on still higher energy costs. Despite the recent plunge in oil prices, average gasoline prices rose slightly (0.2%) in July, which, in combination with seasonal factors that should boost gasoline inflation to the upside, means a fair shot of the seasonally-adjust monthly CPI-U gain coming in near or above the consensus expectations of roughly 0.4% (per briefing.com). Any seasonally-adjusted monthly increase exceeding the 0.22% monthly gain seen in July 2007 would directly add to June's annual inflation rate of 5.02%. Where underlying fundamentals favor an upside surprise to market expectations, targeted manipulation remains of very high risk.

Other Troubled Key Series

Federal Deficit -- As discussed in the Opening Comments, the fiscal condition of the U.S. government is in a state of rapid deterioration, due to surging government outlays and otherwise uncontained spending in conjunction with recession-strangled tax revenues. Excluding significant war costs in its July 28th mid-session review, the Office of Management and Budget estimated that the fiscal-year 2008 (year-ended September 30, 2008) budget deficit would total $389 (previously $410) billion dollars, up from $162 billion in 2007, and that the deficit for fiscal-year 2009 would hit $482 billion. Where the 2009 deficit was projected at $407 billion back in February, the forecast change was based on softer economic projections -- but not on a recession.

Yet, evidence continues to mount of weaker-than-anticipated tax collections at both the federal and state levels, due to the deepening recession. For the first ten months of fiscal 2008, federal receipts are down 0.3% from the same period in 2007. As noted in the prior newsletter, the Federal Reserve (Flow of Funds June 2008) estimated that total federal, state and local government receipts fell at seasonally-adjusted annualized rate of 0.22% in first-quarter 2008 from fourth-quarter 2007. While the Fed's numbers are of questionable quality, there are negative implications here both for state and federal conditions and for U.S. Treasury funding needs.

With no allowance for recession in the assumptions underlying the deficit the projections, the final 2008 numbers should be somewhat worse than currently estimated, while the 2009 deficit estimate should see significant further deterioration. Where GDP growth estimates can be gimmicked, incoming tax receipts (based on consistently applied tax policies) remain an independent estimate of underlying economic reality and have started to reflect the economy's mounting problems.

The rolling 12-month deficit through July 2008 stood at $365.5 billion versus $165.8 billion in July 2007, compared with the rolling 12-month deficit through June 2008 of $309.2 billion versus $162.7 billion in June 2007.

Viewing the change in gross federal debt bypasses several of the regular reporting manipulations and is a better indicator of actual net cash outlays by the federal government than is the official, gimmicked deficit reporting.

Gross federal debt stood at $9.585 trillion at the end of July 2008, up $93 billion for the month and up $653 billion from July 2007, which in turn was up $488 billion from July 2006. As of the end of June 2008, gross federal debt stood at $9.492 trillion, up $103 billion for the month, and up

$624 billion from June 2007, which in turn was up $448 billion from June 2006.

The federal government's fiscal 2007 official, accounting-gimmicked deficit narrowed to $162 billion from $248 billion in 2006. Yet for fiscal year-end 2007, the gross federal debt stood at $9.007 trillion, up by $500 billion from 2006, which was up $574 billion from 2005. As discussed in the December 2007 SGS Newsletter's Reporting/Market Focus, the GAAP-based deficit for fiscal-year 2007 topped $4 trillion, which still remains my best estimate.

Initial Claims for Unemployment Insurance -- The ongoing deterioration in the trend of annual change has intensified in recent weeks. On a smoothed basis for the 17 weeks ended August 2nd, annual growth soared to 22.9%, from 18.8% in the 17 weeks ended June 28th and from 14.9% in the 17 weeks ended May 31st. A rising growth trend in new claims is an economic negative.

General background note: More often than not, week-to-week volatility of the seasonally-adjusted weekly claims numbers is due to the Labor Department's efforts to seasonally adjust these numbers around holiday periods ***(such as Labor Day)***. The Labor Department has demonstrated an inability to do such adjusting successfully. When the new claims series is viewed in terms of the year-to-year change in the 17-week (four-month) moving average, however, such generally is a fair indicator of current economic activity.

Real Average Weekly Earnings -- Reflecting catch-up in seasonally-adjusted CPI-W inflation, June's seasonally-adjusted monthly real earnings fell by 0.9%, following a 0.7% decline May and a 0.1% drop in April. Annual change in June tumbled to a 2.4% contraction, following a 1.1% decline in May and a 0.7% year-to-year fall in April.

General background note: Gyrations in the poor quality of reported CPI growth account for most month-to-month volatility in this series. Adjusting for the major upside biases built into the CPI-W inflation measure used in deflating the average weekly earnings, annual change in this series shows the average worker to be under severe financial stress in an ongoing structural recession (see the *Hyperinflation Special Report* of April 8, 2008).

Retail Sales -- As discussed and graphed in the Opening Comments, and as detailed in today's (August 13th) and July 15th's *Flash Updates*, retail sales have continued to signal a deepening recession, with ongoing real (inflation-adjusted) contractions on a monthly, quarterly and annual basis. The Census Bureau reported that monthly seasonally-adjusted July retail sales fell by 0.12% (up 0.11% net of revisions) +/- 0.6% (95% confidence interval), following a revised 0.35% (previously 0.07%) increase in June. On a year-to-year basis, July retail sales rose by 2.63%, following a revised June gain of 3.35% (previously 3.04%). In terms of real growth, however, both the monthly and annual rates of change continued in contraction, given the likely reporting of tomorrow's July 2008 CPI-U estimate. Despite the positive impact of tax-rebate checks, real second-quarter retail sales contracted for the fourth consecutive quarter, and the July data are setting the pattern for a fifth such consecutive contraction.

***Core Retail Sales*.** Consistent with the Federal Reserve's predilection for ignoring food and energy prices, "core" retail sales -- retail sales net of grocery store and gasoline station revenues -- fell by 0.33% (up 0.03% net of revisions) in July versus a revised 0.27% (was 0.68%) decline in June, against the official aggregate drop of 0.12% in July and the revised 0.35% gain in June. It is important to note that the physical volume of gasoline consumption has started to decline in response to high gasoline prices, so the inflation-adjusted retail sales number should take a bigger hit than seen in the "core" rate. On an annual basis, July "core" retail sales fell by 0.53% versus a revised June increase of 0.44%, previously a 0.09% contraction.

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Next Release (September 12): With the tax rebate checks out of the way, underlying fundamentals suggest ongoing severe weakness, with a fair downside risk for August retail sales growth against what likely will be an overly optimistic consensus forecast. Any gains should continue to be due to inflation -- not to increased consumer purchasing power -- with sharp contractions likely continuing in the monthly and annual growth rates.

Industrial Production -- As discussed in the July 16th *Flash Update* and as graphed in the Opening Comments, June industrial production continued to signal a contracting economy. As reported by the Federal Reserve, monthly seasonally-adjusted June industrial production rose by 0.5% (0.7% net of revisions that stretched back over six months). Such followed an unrevised 0.2% decline in May. The monthly gain was attributed to surging auto production following the end of a strike.

Despite the revisions erasing the annualized 0.1% quarterly contraction previously reported for the fourth quarter (now up by 0.5%), the second quarter was reported with a sharp, annualized 3.1% contraction, common to recessions. Year-to-year growth was 0.3% in June, up from a revised 0.2% gain (was a 0.1% contraction) in May. Year-to-year change in the second quarter dropped sharply to 0.3% from 1.8% in the first quarter.

Next Release (August 15): The July production numbers should resume a pattern of ongoing monthly contractions, against expectations of a flat monthly performance. The erratic but generally slowing annual growth rate is a fair bet to turn negative, again. Such would be consistent with the manufacturing contractions still signaled regularly by the purchasing managers survey (before recent re-formulation).

New Orders for Durable Goods -- As discussed in the July 30th *Flash Update* and in the Opening Comments, durable goods orders sank, again, year-to-year. The regularly-volatile new orders for durable goods series was reported by the Census Bureau as up by 0.8% (0.8% net of revisions) for the month of June on a seasonally-adjusted basis. Such followed an upwardly revised 0.1% (previously unchanged) monthly gain in May. Minor fluctuations in monthly growth for this high-volatility series are meaningless, especially against consensus estimates, except for the occasional overreaction hyped in the equity markets, as followed the June release.

Of significance, however, was that the series contracted on a year-to-year basis (before any adjustment for inflation) for the fourth straight month: down 0.8% March, down 3.8% April, down 1.4% May, down 1.1% June. Where the series also contracted year-to-year in the second quarter, it also showed the third consecutive quarter-to-quarter contraction, an event not seen historically outside of recessions.

The closely followed nondefense capital goods new orders fell by 3.2% in June, following a revised 0.2% (previously 0.4%) gain in May. June's year-to-year change turned to a decline of 6.2%, following a revised 1.3% (previously 0.4%) gain in May.

General background note: Durable goods orders lost its status as a solid leading economic indicator when the semi-conductor industry stopped reporting new orders in 2002.

Trade Balance -- The Bureau of Economic Analysis and the Census Bureau reported a continued and largely unbelievable reduction in the monthly June trade deficit. The number was strong enough to place fair odds on a strong upward revision to already-overstated second-quarter GDP growth.

The seasonally-adjusted monthly trade deficit for June was reported to have decreased to $56.8 billion from a revised $59.2 (previously $59.8 billion) in May. The data appear unreliable, with

unusual paperwork flows from the ports likely distorting current reporting.

The reported average unit price for imported oil rose in June to $117.13 per barrel, from $106.28 in May. Yet, and the average barrels per day reported as imported for June plunged by 7.5% year-to-year. While U.S. oil imports may be softening, along with oil consumption, there are indications of some underreporting of oil imports in the trade data, versus statistics otherwise available through the U.S. Department of Energy. More will follow on this in a later newsletter.

Next Release (September 11): Images of underlying reality are not strong in this increasingly damaged series. Given their use as a prop to GDP reporting, questionable trade data are likely to continue through the November election. Accordingly, the July and August numbers (needed for the third-quarter GDP estimate just before the election) are likely to show a continued narrowing of the deficit, despite any anecdotal evidence to the contrary.

Consumer Confidence -- As discussed in the July 30th *Flash Update*, the ongoing weakness evident in consumer housing and retail sales activity is consistent with the historic annual plunges being reported in the June and July consumer confidence measures.

The Conference Board's Consumer Confidence measure gained 1.8% in July (versus down 12.2% in June) and the Reuters/University of Michigan's Consumer Sentiment measure rose by 8.5% in July (versus down 5.7% in June). Similar monthly patterns were seen last year, however, and greater significance was evident in the pattern of annual change.

Consumer Confidence in July fell by the largest annual amount in the history of the series, down by 53.6% year-to-year, breaking the prior month's record annual contraction of 51.7%. July Consumer Sentiment fell by 32.3% year-to-year, the steepest annual contraction shy of June's record 33.9% drop. These lagging, not leading indicators confirm that the economy has been in a deepening recession.

General background note: The Conference Board measure is seasonally adjusted, which can provide occasional, but significant distortion. The adjustment does not make much sense and is of suspect purpose, given that the Conference Board does not release the unadjusted number. The Reuters/Michigan survey is unadjusted. How does one seasonally-adjust peoples' attitudes? Also, beware the mid-month Consumer Sentiment release from Reuters/University of Michigan. The sampling base is so small as to be virtually valueless in terms of statistical significance.

Short-Term Credit Measures -- Annual growth in both consumer credit and commercial borrowing has started to slow markedly, intensifying recession pressures and highlighting ongoing difficulties the Federal Reserve is having in stabilizing solvency issues in the U.S. banking system. The intensifying decline in annual growth for commercial paper outstanding has continued to deepen as growth in commercial and industrial bank loans has slowed.

For seasonally-adjusted consumer credit, which includes credit cards and auto loans, but not mortgages, annual growth was reported at 5.6% in June, a notch higher than the 5.5% reported in May, but down sharply from 6.0% in April and from 5.8% in March.

General background note: As reported by the Fed (Flow of Funds June 2008), home equity loan growth slowed from a year-to-year 6.1% growth rate in the fourth quarter to 4.9% in the first-quarter. The data, which are of questionable quality, show the seasonally adjusted annualized rate of growth in home equity loans slowed from $92.4 billion in third-quarter 2007, to $42.8 billion in the fourth quarter, to an outright contraction of $7.3 billion in first-quarter 2008.

In the current environment, where inflation-adjusted growth in income is not adequate to support meaningful growth in the personal consumption component of GDP, GDP growth only can come from temporary debt expansion or savings liquidation. Accordingly, stagnating growth and eventual contraction in consumer debt remains an ongoing constraint on economic activity.

Annual growth in commercial borrowing varied sharply, but growth patterns have started dropping in tandem for both commercial paper and commercial and industrial loans. Annual change in July commercial paper outstanding showed a 20.8% contraction, deepening from contractions of 19.0% in June, 17.2% in May and 13.9% in April.

While annual growth in June commercial and industrial loans rose by a still healthy 18.7%, such has slowed from growth of 19.9% in May, 21.2% in April and 21.6% in March. The instability in commercial paper is ongoing. With the relative offset in commercial and industrial loans stalling, resultant credit difficulties increasingly will inhibit broad business activity.

Producer Price Index (PPI) -- As discussed in the July 15th *Flash Update*, the seasonally-adjusted June producer price index (PPI) increased by 1.8% (1.6% unadjusted) for the month, up minimally from May's 1.4% (1.6% unadjusted), and above consensus forecasts. Annual inflation for June jumped to 9.2% from May's 7.2% rate, per the Bureau of Labor Statistics (BLS).

Both food and energy inflation continued to appear to be understated, meaningfully, while the monthly "core" inflation rate remained at the unbelievably low monthly rate of 0.2%, as discussed in the Opening Comments.

On a monthly basis, seasonally-adjusted June intermediate goods rose by 2.1% (2.9% May), crude goods gained 3.7% (6.7% May). Year-to-year inflation, remained excessive, but still shy of a real world that had seen a near-doubling in oil prices year-to-year, with June intermediate goods up by 14.5% (12.6% May) and with crude goods up by 45.5% (41.5% May). Crude energy materials rose by a modest 72.1%.

Next Release (August 19th): Given what appears to be ongoing deliberate understatements of the monthly CPI and PPI inflation rates (see Opening Comments), the PPI likely will be subject to further understatement in July. Allowing for the ongoing regularly random volatility of the monthly price variations, PPI inflation reporting over the next six-to-nine months, however, generally should favor upside surprises in official results, thanks in particular to the broad-based impact of higher oil prices.

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Better-Quality Numbers

General background note: The following numbers are generally good-quality leading indicators of economic activity and inflation that offer an alternative to the politically-hyped numbers when the economy really is not so perfect. In some instances, using a three-month moving average improves the quality of the economic signal and is so noted in the text.

Economic Indicators

Purchasing Managers Survey: Manufacturing New Orders -- But for the reformulation of the purchasing managers manufacturing index (PMI) back in January, the June and July index readings both would have remained below 50.0, signaling a contracting manufacturing sector and a recession. The Institute for Supply Management (ISM) reweighted its key index so that the PMI would better match GDP results. While the effort was well intentioned, altering the data to match the extremely overstated GDP growth rates damaged the reporting quality of the PMI. Fortunately, however, the more meaningful components of the index were not affected by the efforts to match the flawed government data.

The July PMI eased to the borderline growth-contraction reading of 50.0, from 50.2 in June and the May reading of 49.6, which had been the fourth consecutive monthly recession reading. While the ISM uses an index reading of 41.1 (in its recently reformulated index) as the break-point between recession in the broad economy and expansion, a reading below 50.0 means a contracting manufacturing sector. The 50.0 mark works out still as a solid broad recession signal in my analyses that are unfettered by reliance on GDP data for a recession signal.

The various components of the ISM composite indices are diffusion indices, which are calculated as the percent of positive responses from the ISM survey plus one-half of the neutral or unchanged responses. Hence, a reading below 50.0 indicates a contracting series.

The July orders index showed continuing contraction (holding below 50.0), falling to 45.0 from 49.6 in June and from 49.7 in May. The new orders have been in actual contraction since December 2007. Distortions from the seasonal factors calculated by the Department of Commerce can be minimized by viewing the series using year-to-year change on a three-month moving average basis. On that basis, the July new orders index fell by 17.1%, following respective June and May declines of 16.8% and 15.2%.

The new orders component of the purchasing managers survey is a particularly valuable indicator of economic activity. The measure gradually has notched lower from its peak annual growth of 35.5% in April of 2004. As an SGS early-warning indicator of a major economic shift, new orders breached its fail-safe point in mid-2005, signaling pending recession.

Also a significant measure, the manufacturing employment component bounced to 51.9 in July, up from 43.7 in June and 45.5 in May.

Service Sector Composite Index. This series does not have much meaning related to overall business activity, since new order activity at law firms, dentists, hospitals or fast-food restaurants has little obvious relationship to broad economic activity. With that as background, the July services composite index notched higher to 49.5, from 48.2 in June, but down from 51.7 in May.

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Both the services employment and prices paid components, however, have some meaning. Covering the real estate and banking industries, among others, the July employment component remained below 50.0, at 47.1, up from 43.8 in June, but down from 48.7 in May. The extremely high prices paid component for both indices is covered in the Inflation Indicators.

Help-Wanted Advertising Index (R.I.P) -- (Newspapers and On-Line) -- The Conference Board has ceased issuing press releases on its help-wanted advertising in newspapers series, but the monthly data still are available for some undetermined period of time, upon request.

Based on such a request, the seasonally-adjusted June help-wanted advertising index notched higher to 18 in June, up from 17 in May. The May reading had been the lowest level seen since the index was first calculated at the end of President Harry Truman's term in office.

The June reading was down by 30.0% year-to-year, versus a 37.0% decline in May. The annual change in the three-month moving average as of June was a 35.4% contraction, versus a 36.5% contraction in May. Despite some of the historic weakness in the series being due to the loss of newspaper business to the Internet, and despite its looming abandonment by the Conference Board, the HWA remains a solid leading indicator to the broad economy and to the monthly employment report. It continues to signal severe deepening in the recession and ongoing deterioration in labor-market conditions.

Where the HWA series does not include a measure of on-line advertising, recent indices developed to measure Internet activity have serious definitional problems and still are too young to be meaningful indicators. That said, the Conference Board has reported that annual growth in its nascent on-line measure of help-wanted advertising has contracted on a year-to-year basis in each month from April through July 2008. Such likely is not a good sign for national employment or for broad economic activity.

Housing Starts -- As discussed in the July 22nd *Flash Update*, the consistency of the government's residential construction measures been compromised. The Census Bureau's June reporting of building permits and housing starts was seriously distorted by changes in New York City construction codes that triggered a surge in reported activity that was little more than renewed paperwork.

Where seasonally-adjusted June housing starts was reported up by 9.1% for the month, such would appear to have been a contraction net of the New York City activity. May's monthly change revised to a 0.4% decline from an initial report of a 1.8% drop. Annual change likewise was distorted, down 26.9% versus May's revised 35.7% decline. I am working on a temporary adjustment to the series so to as allow for more-meaningful, period-to-period comparisons, which should be in place for the next newsletter.

In home sales data, the seasonally-adjusted June new home sales fell by 0.6% (up by 3.5% net of revisions) +/- 14% (95% confidence interval), which was not statistically distinguishable from a contraction. The June gain followed a revised 1.3% (previously 2.5%) monthly decline in May. On a year-to-year basis, however, June new home sales dropped by 33.2%, following a revised 37.8% (previously 40.3%) annual plunge in May.

Increasingly reflecting the impact of foreclosures, existing home sales in June fell by 2.6%, after a 2.0% gain in May. Year-to-year sales fell by 15.5% in June, following a 15.9% decline in May.

Net of increasing stress in the reporting of the data, the housing market remains in a severe and protracted recession.

Inflation Indicators

Money Supply -- See the August 3rd *Money Supply Special Report* for a discussion of the practical measurement and analytical uses of money supply in assessing inflation prospects.

Annual growth in the seasonally-adjusted SGS-Ongoing M3 is estimated to have slowed further to 15.4% in July, following estimated annual growth of 15.8% in June, 15.9% in May, 16.4% in April and a record-high 17.4% in March. The continued slowing in annual growth in June and July (the monthly data continue to expand) appears tied to the still-intensifying problems in the banking system, and well may foreshadow near-term systemic jolts and still-further liquidity expansion by the Fed.

Outside of the last several months, the prior historic high of 16.4% was seen in June of 1971, two months before President Nixon closed the gold window and imposed wage and price controls. While the July's growth remains shy of 1971's high, it still promises heavy upside inflation pressure into first-half 2009.

For July 2008, annual growth for monthly M1 is estimated to have risen to 2.0% from 1.5% in June, continuing a positive swing from a 0.6% contraction in May and ending two years of flat-to-minus annual growth. July annual M2 growth notched higher to 6.2%, from 6.1% in June, but still was down from 6.4% in May. The relative pick-up in M1 growth appears to be due to funds shifting from accounts in the broader M2 and M3 measures (particularly institutional money funds and large time deposits) into M1 checking accounts and currency. Such may reflect increased wariness of the part of large depositors.

Shadow Government Statistics Ongoing M3 (r)
(Estimated seasonally-adjusted monthly average, $ Trillions)

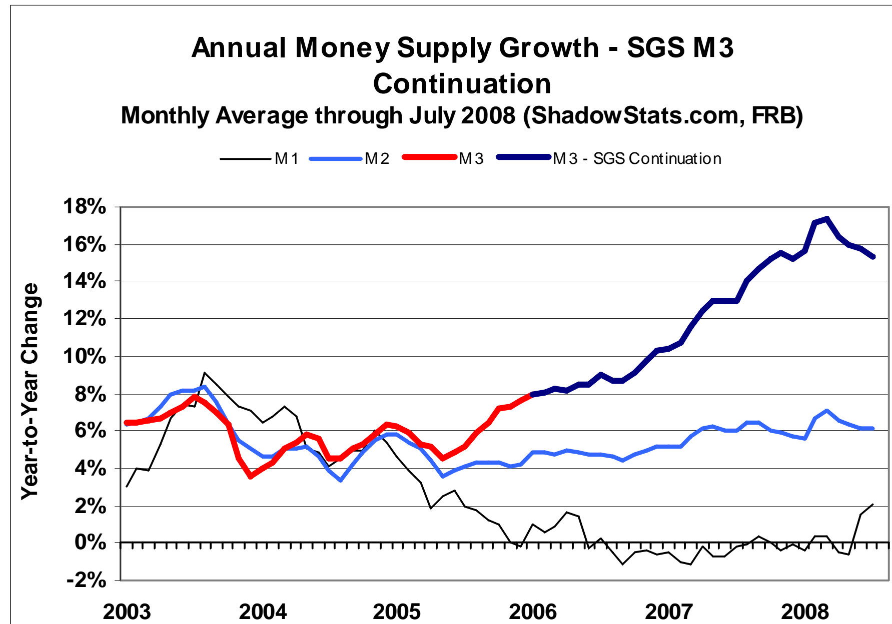
Feb 06	10.311	Oct	10.979	Jun	11.950	Feb	13.390
Mar	10.364	Nov	11.094	Jul	12.055	Mar	13.575
Apr	10.425	Dec	11.226	Aug	12.261	Apr	13.646
May	10.504	Jan 07	11.314	Sep	12.443	May	13.764
Jun	10.575	Feb	11.436	Oct	12.651	Jun	13.836
Jul	10.672	Mar	11.563	Nov	12.823	Jul (p)	13.907
Aug	10.755	Apr	11.720	Dec	12.931		
Sep	10.852	May	11.872	Jan 08	13.088		

(r) Revised, based on extensive FRB historical revisions. (p) Preliminary.

NOTE OF CAUTION: The estimates of monthly levels best are used for comparisons with other dollar amounts, such as nominal GDP. While the estimates are based on seasonally-adjusted Federal Reserve data, great significance cannot be read into the month-to-month changes, as was the case even when the Fed published the series. The most meaningful way to view the data is in terms of year-to-year change.

General background note: Historical annual growth data for the money supply series, including the SGS-Ongoing M3 estimates, are available for download on the Alternate Data page of www.shadowstats.com. See the August 2006 SGS Newsletter for methodology. The indicated M3 levels are our best estimate and are provided at specific subscriber request. Keep in mind that regular revisions in the related Fed series affect historical M3. Usually, annual growth rates hold,

although levels may shift a little. We have not attempted, nor do we plan to recreate a revised historical series for an M3 monthly-average level going back in time. The purpose of the SGS series was and is to provide monthly estimates of ongoing annual M3 growth. We are comfortable with those numbers and that our estimated monthly growth rates are reasonably close to what the Fed would be reporting, if it still reported M3.



Purchasing Managers Surveys: Prices Paid Indices -- The July 2008 prices paid indices remained extremely high, though off the peaks seen in June for both of the purchasing managers composite surveys. The indices continued to reflect strong upside inflation pressures from a variety of factors, including high oil prices and a weaker U.S. dollar, and they continued to signal broad inflation problems ahead.

On the manufacturing side, the July price index eased to 88.5 from June's 28-year high reading of 91.5, and following May's reading of 87.0. On a three-month moving average basis, July's year-to-year gain was 30.9%, versus 24.1% in June and 21.7% in May. The manufacturing price indicator is not seasonally adjusted and, therefore, is generally the better indicator of pricing activity.

On the non-manufacturing side, the seasonally-adjusted July prices diffusion also eased, falling back to 80.8 from 84.5 in June, but up from 77.0 in May. On a three-month moving-average basis, July's annual gain was 25.5%, versus 21.0% in June and 15.5% in May.

General background note: Published by the Institute for Supply Management (ISM), the prices paid components of the purchasing managers surveys are reliable leading indicators of inflationary pressure. The measures are diffusion indices, where a reading above 50.0 indicates rising prices.

Oil Prices -- Extreme price volatility has been the recent norm for oil trading, but the general outlook for inflation continues to be strongly on the upside, despite any relative near-term oil-price softness. The economy still suffers from oil priced in excess of $100 per barrel, where severe inflation damage already was ingrained in the system when oil broke above the $90 per barrel. Implications for inflation and real GDP growth remain extremely ominous for the balance of 2008 and into 2009.

After exploding to record-level closing spot price of $145.66 for West Texas Intermediate (WTI) on July 11, 2008, the price of oil has plunged to the $115 area, as we go to press just a month later. Nonetheless, I would be extremely surprised if we have seen the near-term peak in oil.

Despite heavy oil selling in late-July, July's monthly average spot price for WTI (St. Louis Fed) was $133.44 per barrel, down just 0.4% from June's $133.93 historic-high average, which, in turn was up by 6.8% from May's $125.39. For July 2008, the year-to-year increase in price level was 79.9%, down from June's 98.5% and May's 97.6% annual rates of increase.

The oil market, again, is highly volatile and sensitive to minor surprises or speculation in terms of possible U.S. Gulf Coast hurricanes or potential military action against Iran by Israeli and/or U.S. forces. Despite a deepening U.S. recession and increasing indications of a global recession, and regardless of any continued extreme short-term price volatility, meaningful upside risks to oil prices remain in place over the longer term. In particular, pressures remain in place from the still-unfolding dollar catastrophe, irrespective of near-term dollar gains. Further pressures come from ongoing OPEC needs, increasingly volatile global military and political tensions, and other supply and demand risks/issues.

Though a reversal in questionable seasonal factors has helped to resume spiking basic annual CPI inflation in the United States, energy inflation measures still remain well shy of reality. The gimmicked "core" inflation measures -- net of changes in food and energy prices -- also should be increasing, but, somehow, the oil-related costs just do not seem to get into the government's inflation reporting. This is despite high oil prices continuing to work their way through all levels of U.S. economic activity, ranging from transportation and energy costs, to material costs in the plastics, pharmaceutical, fertilizer, chemical industries, etc. These broad inflationary pressures will remain intact despite any near-term oil price gyrations.

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