John Williams'

Shadow Government Statistics

Analysis Behind and Beyond Government Economic Reporting

Number 48

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Multiple-Dip Depression Unfolds

Solvency Crisis to Engulf U.S. Government Finances

Stimulus Efforts Would Enhance Hyperinflation Risk

Broad Money Growth Spikes

OVERVIEW -- OPENING COMMENTS

Obama Administration to Push Practical Limits of Effective U.S. Fiscal Bankruptcy

By April, the rapidly deteriorating recession will be viewed commonly as the worst downturn since the Great Depression. Fearing same, the incoming Obama Administration is promising stimulus in the form of massive federal spending. Concerns about the government's fiscal condition can wait until the economy recovers, we are being told. A similar pacifying assurance presumably extends to inflation concerns as well.

Unfortunately, with the economy in a structural downturn (as discussed in the last newsletter) and with the U.S. government effectively bankrupt (as discussed in the Reporting/Market Focus section), there can be no rapid or normal recovery. As inflationary pressures mount anew and the financial markets increasingly shun U.S. Treasuries, an inflationary depression can evolve quickly into a hyperinflationary great depression. Although hyperinflation became inevitable in the last decade, the onset of the process just recently was triggered by Fed and the Treasury actions in addressing the systemic solvency crisis. The process would be accelerated by unfettered and

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unfunded government spending that appears to loom in early 2009.

The recession is official now, but, as usual, its depth and length have been underestimated. Ahead lies continued economic downturn that likely will evolve as a multiple-dip depression and ultimately a great depression, as hyperinflation eventually kicks in and collapses normal commercial activity. The historical context of the current structural downturn in economic activity was discussed in some detail in the *SGS Newsletter No. 47* of November 14, 2008, and is included here by reference.

On the plus side, the tumultuous financial markets appear to have calmed a little, and the Federal Reserve's panicked liquefaction of the U.S. financial system appears to have triggered some positive early response in bank lending. Yet, along with any relative market tranquility, growth in the broad money supply is spiking anew, and the U.S. dollar has come under renewed selling pressure. The monetary and currency developments bode poorly for the inflation outlook -- despite the recent collapse in oil prices and a possible negative reading for December annual CPI -- and intensified dollar selling even could start to boost dollar-based oil prices, again. In the year ahead, dollar weakness, an inflation threat (not broadly perceived, yet) and rapidly expanding global political tensions, all will be fodder for the gold market.

Over the long-term, the broad outlook is little changed. As to the equity and credit markets, difficult times lie ahead, with impaired corporate revenues and profits in the deteriorating economic circumstance, and with long-term interest rates likely to move much higher. Rates should rise as financial-panic pressures subside and funds flow out of U.S. Treasuries in response to ongoing dollar debasement (inflation). Again, over the long-term, the U.S. dollar should suffer significant selling, with both gold and silver rallying sharply, partially in response to the greenback's problems.

Formal Deflation in December CPI? Watch Out for 2009! With collapsing oil prices having pushed the reported annual CPI-U down to 1.0% in November, continued pressures may push the annual CPI-U inflation rate negative in December (see the CPI comments in the Reporting section). While such likely would be extremely shallow and short-lived, it would be formal deflation, nonetheless, the first since the 1950s. Of course, CPI reporting methodologies have changed meaningfully in the last 60 years, and as indicated by the SGS-Alternate CPI measures, today's zero inflation would be around three-percent or eight-percent, using the respective CPI methodologies in place as of 1990 or 1980.

With oil and gasoline prices having continued to sink into December, with the dollar having strengthened into December, with M3 growth and money velocity likely having slowed into November, and with the prices-paid component of the December purchasing managers manufacturing survey at a 60-year low, it could be hard to argue that much higher inflation looms in 2009.

That said, oil and gasoline prices appeared to be close to a bottom at year-end 2008, with selling pressures mounting anew on the U.S. dollar. A slowing global economy has softened demand for oil, but OPEC has been and likely will continue to address that with production cuts. Also, with the U.S. election out of the way, political tensions in the Middle East and elsewhere around the globe are on the rise again.

Key to the pricing of dollar-denominated commodities -- particularly oil -- is the value of the U.S. dollar against other currencies. The greenback was manipulated higher, after the Bear Stearns crisis in March, and then suffered extreme distortions as the global financial meltdown forced liquidations of various financial instruments among troubled firms. Dollar fundamentals remained extremely negative, however, and, in the second half of December, net selling pressure resumed on the U.S. currency. Such likely will intensify in the months ahead. If so, not only

should oil prices bottom, but they also likely will begin to turn sharply to the upside, once again (see the U.S. Dollar and Oil comments in the respective Markets and Reporting sections).

Most significantly, however, annual M3 growth resumed its upswing in December, beginning to absorb the extreme liquidity pumped into the system by the Federal Reserve. With annual M3 growth rising to an estimated 10.4% in December, from 8.9% in November, growth topping the 17.4% historic high seen in March 2008 likely will be seen before March 2009. Such levels exceed the 16.4% previous historic high of June 1971, which was two months before President Nixon closed the gold window and instituted wage and price controls. Shy of hyperinflation, consumer inflation should hit double digits in 2009.

As discussed in the Reporting/Market Focus, the U.S. government effectively is bankrupt. Yet, extreme fiscal stimulus appears to be likely early in the upcoming Obama Administration, along with a further sharp and immediate increase in U.S. Treasury funding needs. As U.S. and global investors increasingly shun investment in U.S. Treasuries, the Federal Reserve will be forced to monetize that debt, as the lender of last resort to the U.S. government. Accordingly, what likely will become in 2009 the worst U.S. consumer inflation in living memory, increasingly will have the potential to evolve into hyperinflation before the end of the New Year. The estimated timing for the onset of the hyperinflationary great depression discussed in the *Hyperinflation Special Report* of April 8, 2008 has been narrowed to a range of 2009 to 2014.

Monetary Excesses Continue. As shown in the following graphs, total reserves of depository institutions (FRB, not seasonally adjusted) have continued to surge, rising to $824.1 billion in the two weeks ended December 17th, from $645.6 billion in the prior period, and from $44.2 billion as recently as September 10th. (Late reporting shows total reserves at $856.1 billion in the two weeks ended December 31st). The increase in nonborrowed reserves just means that banks have been placing their cash in reserves faster than the Fed has been lending (the Fed pays interest now on reserves).

Where most of the growth has continued to be in excess reserves, such suggests that the banks generally have not resumed fully-normal lending. Of significance, though, required reserves have been holding above $53 billion, at $53.2 billion in the two weeks ended December 17th ($53.8 in the December 31st period), up from $41.9 billion in the two weeks ended September 10th. Annual growth in required reserves has spiked to 32.0% (as reflected in the graph) and is growing at the fastest pace of the post-World War II era. This indicates that the excess reserves have started entering the system, albeit slowly, but at a pace fast enough to spike broad money growth in December.

The seasonally-adjusted St. Louis Fed Monetary Base -- the Fed's traditional tool for adjusting money supply growth -- has continued to spike thanks to the growth in reserves. The monetary base basically includes the currency component of M1 and total bank reserves. Year-to-year growth for the two weeks ended December 17th was a record 97.5%, as shown in the graph. Late reporting for the December 31st period shows annual growth of 99.4%.

Fed apologists offer assurances that the U.S. central bank will dry up excess liquidity when the solvency crisis passes, with no net impact on money supply growth or inflation prospects. Assurances also are being put forth that the surge in government borrowing will be absorbed happily by the usual forced lenders, and that the Fed will not have to monetize Treasury debt further.

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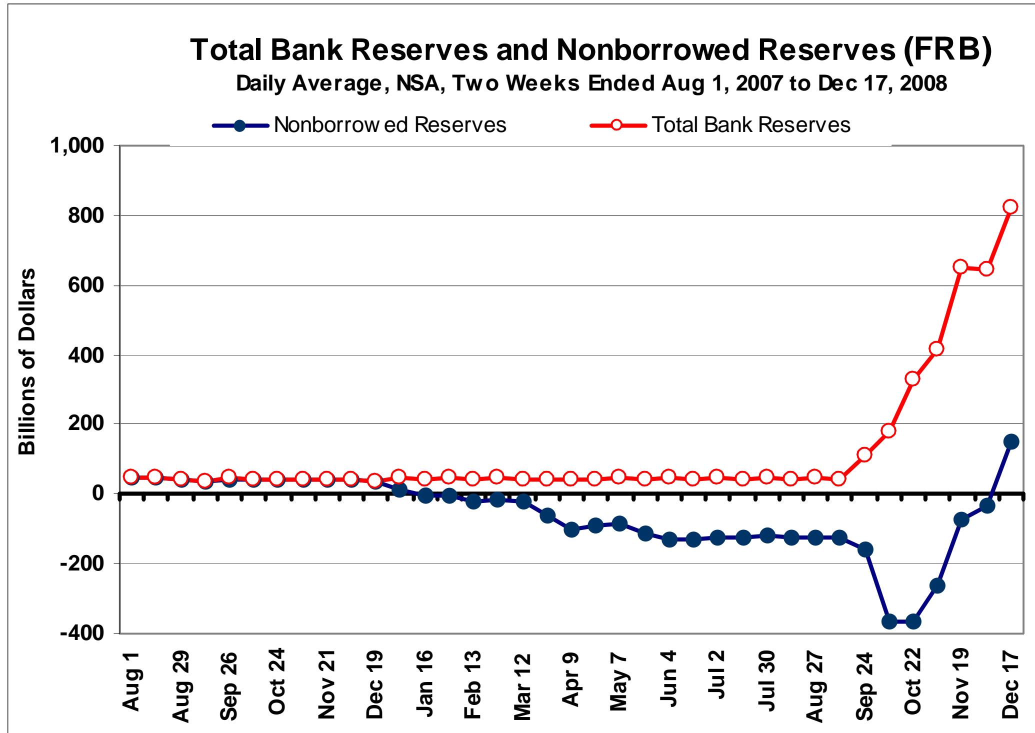
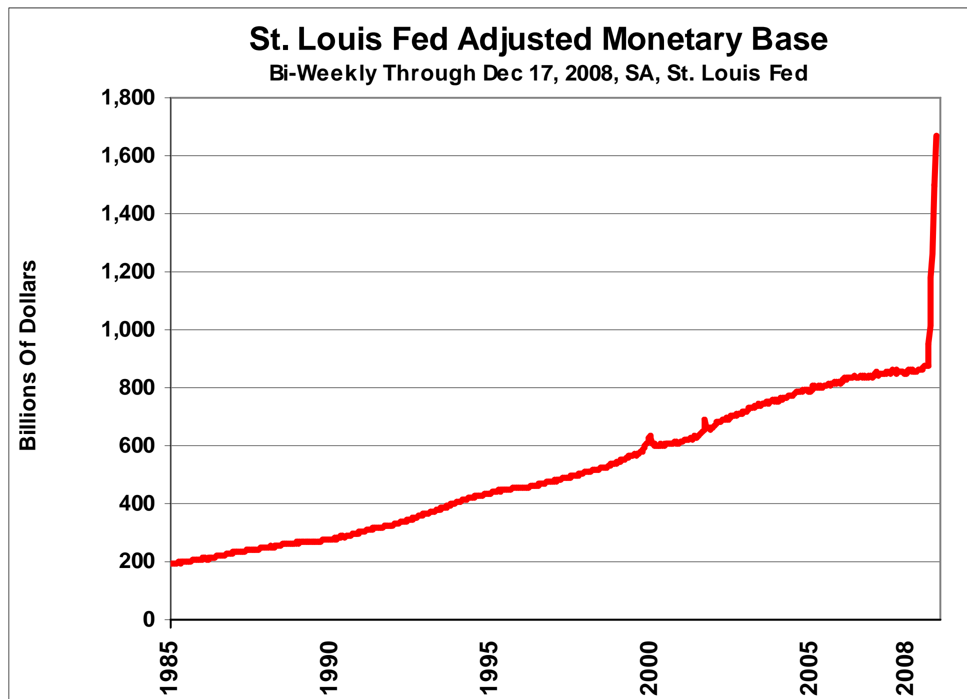
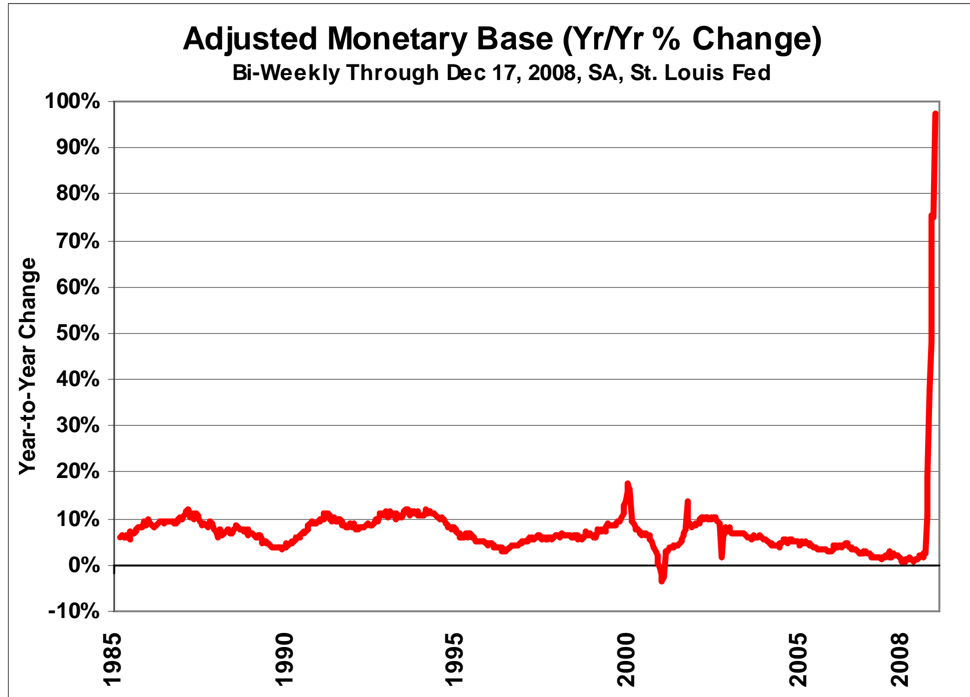
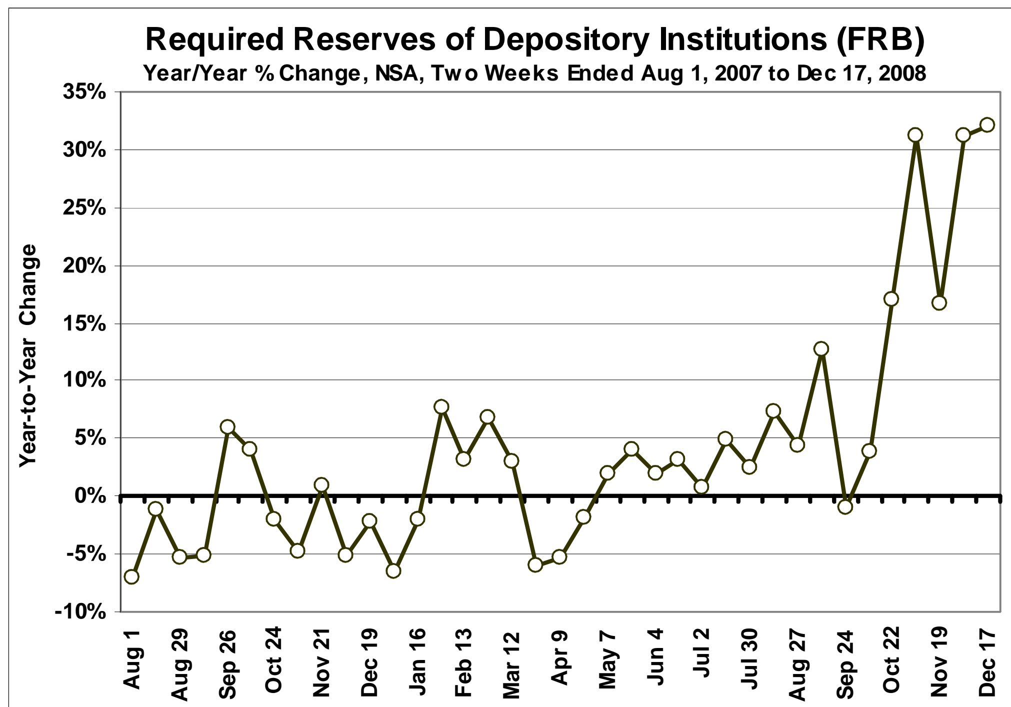

Total Bank Reserves and Nonborrowed Reserves (FRB)
Daily Average, NSA, Two Weeks Ended Aug 1, 2007 to Dec 17, 2008
Nonborrowed Reserves
Total Bank Reserves
Billions of Dollars
1,000
800
600
400
200
0
-200
-400
Aug 1
Aug 29
Sep 26
Oct 24
Nov 21
Dec 19
Jan 16
Feb 13
Mar 12
Apr 9
May 7
Jun 4
Jul 2
Jul 30
Aug 27
Sep 24
Oct 22
Nov 19
Dec 17

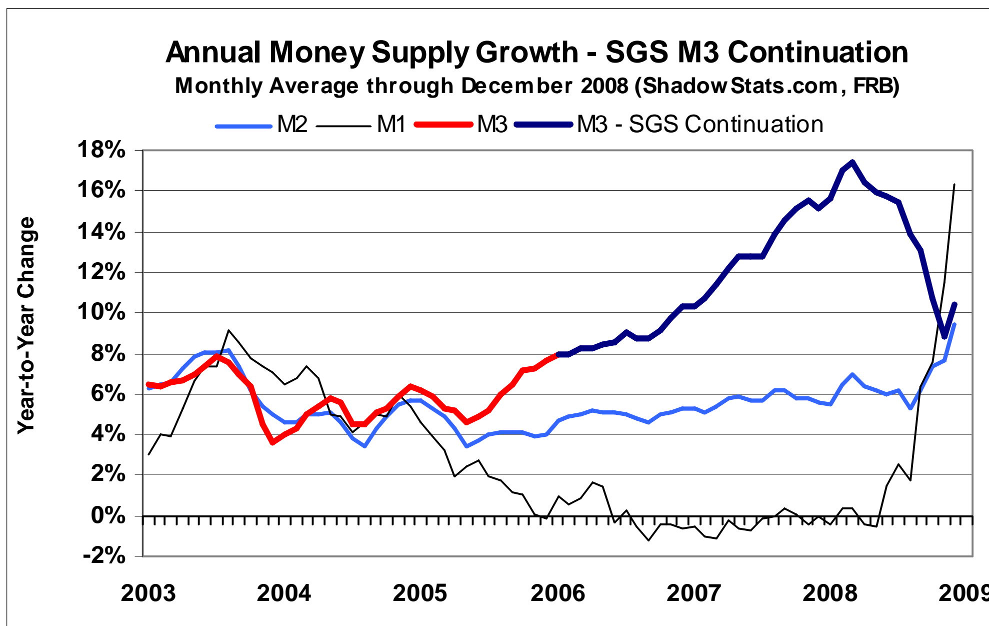

St. Louis Fed Adjusted Monetary Base
Bi-Weekly Through Dec 17, 2008, SA, St. Louis Fed
Billions Of Dollars
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0
1985
1990
1995
2000
2005
2008


Adjusted Monetary Base (Yr/Yr % Change)
Bi-Weekly Through Dec 17, 2008, SA, St. Louis Fed
Year-to-Year Change
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
-10%
1985
1990
1995
2000
2005
2008


Required Reserves of Depository Institutions (FRB)
Year/Year % Change, NSA, Two Weeks Ended Aug 1, 2007 to Dec 17, 2008
Year-to-Year Change
35%
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
Aug 1
Aug 29
Sep 26
Oct 24
Nov 21
Dec 19
Jan 16
Feb 13
Mar 12
Apr 9
May 7
Jun 4
Jul 2
Jul 30
Aug 27
Sep 24
Oct 22
Nov 19
Dec 17

Such is nonsense! Money growth has started to accelerate, and there is little that can be done to build global confidence in U.S. Treasuries and the U.S. dollar, given the recent and promised new debasement of the U.S. currency. The Fed is not going to try to collapse money growth with declining economic activity already entering depression. The Fed faces a liquidity trap. It can get the money supply to grow and inflation to spike, but it will not be able to get the economy to rally.

M3 Annual Growth Rebounds. Based on a continuing weekly pickup in key M3 components, the pattern of slowing annual growth seen in the SGS-Ongoing M3 Measure, since April, appears to have bottomed at 8.9% in November. With roughly three weeks of December data in hand, the year-to-year change in the seasonally-adjusted M3 average is estimated to have rebounded to roughly 10.4%. The month-to-month increase in the series -- estimated at roughly 2.3% -- more than offsets the two month-to-month declines seen in October and November. These estimates will be revised in the next two weeks as more-complete information becomes available.



As bank lending went into a deep freeze and individuals moved to cash or Treasury bills in the unfolding financial panic, not only did annual growth in the broad money supply slow, but also the velocity of money -- the speed with which cash turned over in the economy -- likely dropped off sharply.

Now, the financial crisis would appear to have calmed to the point that investors are starting to take cash out of their mattresses, and that banks are beginning to lend somewhat more normally. Given the recent excesses of Fed activity, as reflected in soaring annual growth in bank reserves -- particularly required reserves -- and the monetary base, flow-through to the annual growth in the broad money supply -- as reflected in the

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SGS-Ongoing M3 Measure -- likely will surge to the highest levels seen since before the creation of the Federal Reserve in 1913. As bank lending increasingly returns towards normal functioning, and as cash comes out of the mattresses, the velocity of money also should increase. In conjunction with the rising broad money growth, increasing velocity will offer intensified upside pressure on consumer inflation (see the August 3rd *Money Supply Special Report* for background).

Implications are for a significant pickup in consumer inflation by mid-2009 -- despite a severe economic contraction -- with likely negative impact on the exchange rate for the U.S. dollar, and likely positive impact on precious metals prices and prices for dollar-denominated commodities such as oil.

Worst Economy Since the Great Depression. Whatever comes forth in the Obama Administration's economic stimulus package likely will have more of a positive impact on the general economy than did mailing taxpayers direct cash payments in 2008. The checks to taxpayers hardly created a blip in retail sales and did nothing to address the structural issues in the economy. If the promised stimulus indeed is aimed at creating new employment, the impact would be slower in surfacing, but it could have some dampening effect on the contraction, if the funding of the package can be sold to the global markets.

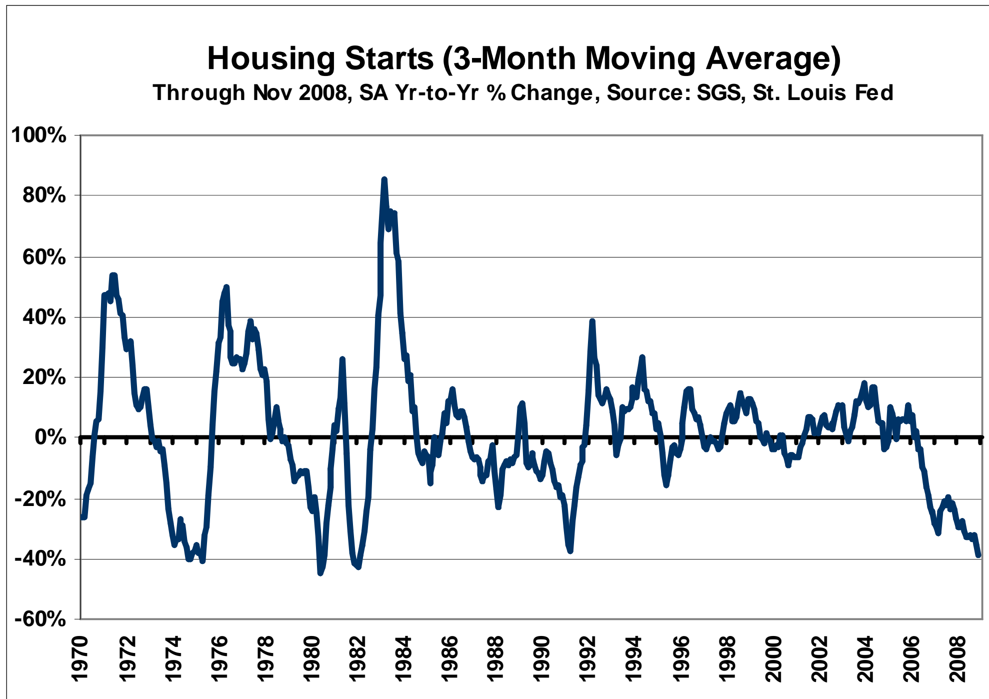
Putting aside philosophical issues as to the relative merits or demerits of the U.S. government increasingly attempting to direct U.S. corporate and/or economic activity (I would argue strongly against such a trend), the new Administration's biggest problems could be with the credit markets, as discussed in the Reporting/Market Focus.

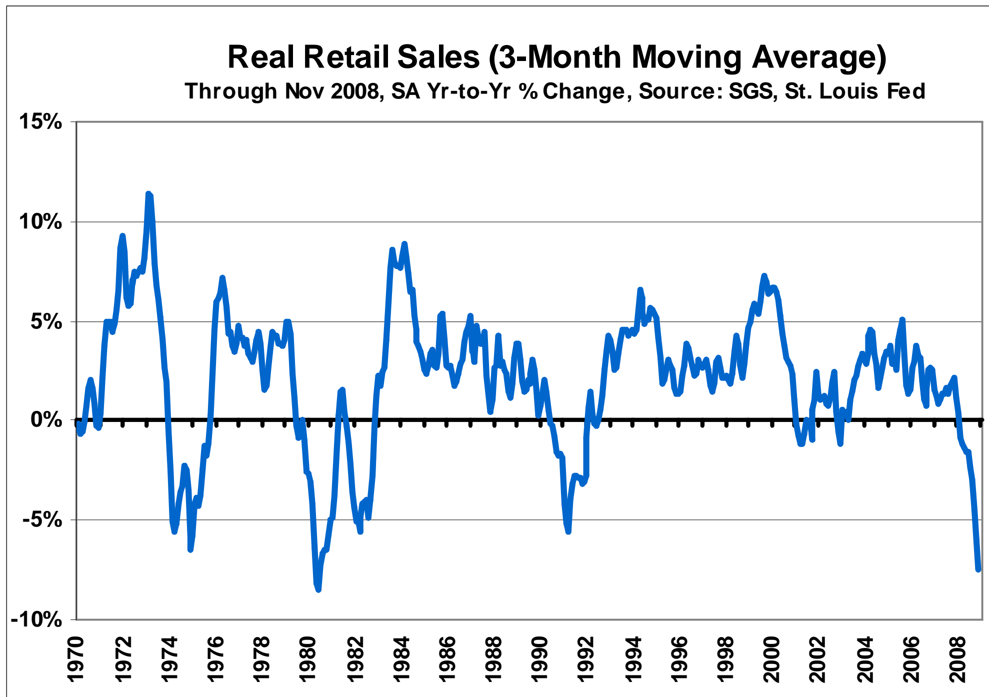
Getting to the current state of the economy, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) -- official arbiter of whether or not the U.S. economy is in recession -- has determined that the U.S. economy peaked in December 2007 and has been in recession since. I argued in the previous newsletter and still contend that the current downturn began in fourth-quarter 2006, a year earlier than the official start. The current downturn is the second downleg of what will become a multiple-dip depression/great depression (again, *SGS Newsletter No. 47* of November 14, 2008 is included here by reference). Economies do not contract in perpetual plunges -- they bounce or bottom-bounce -- and the pending stimulus package conceivably could help trigger such a bottom-bounce, setting the stage for the next downleg in the structural downturn.

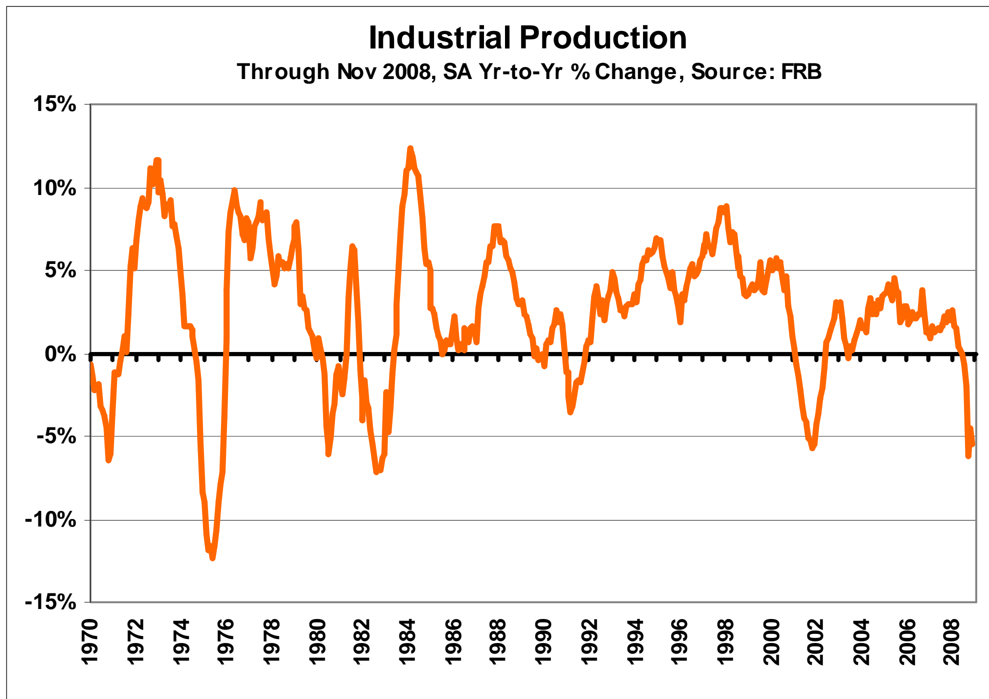
The financial press and Wall Street, of course, will stick with the official version of economic activity, but even that should shift to comparisons with the Great Depression by mid-year. Against its official starting point, the current recession has been ongoing for 13 months and shows no signs of imminent bottoming, where such would be used to mark the recession's end. By April 2009, the recession will be timed as the longest since the Great Depression (its current 13 months ties the length of the second-dip of the Great Depression in that late 1930s), where, at present, its length was exceeded by the 1973 to 1975 recession and by the second leg of the double-dip recession of the early 1980s.

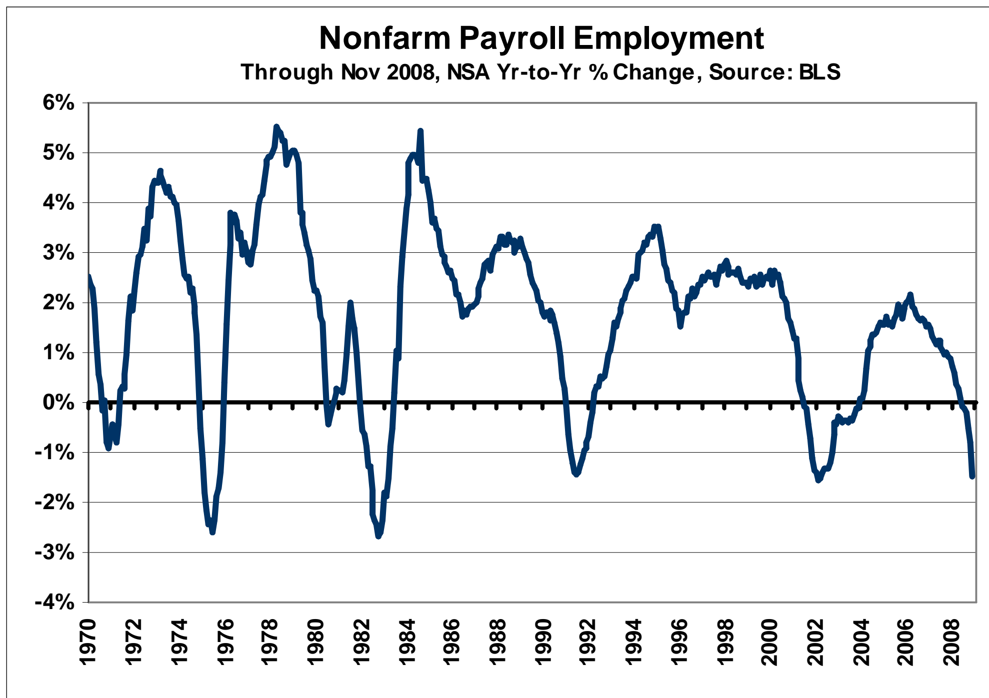
As shown in the accompanying charts of annual growth in key economic indicators, current economic activity already is at the lowest levels seen since the mid-1970's and early-1980's downturns (except for payrolls, which likely will be there in the next monthly reporting).

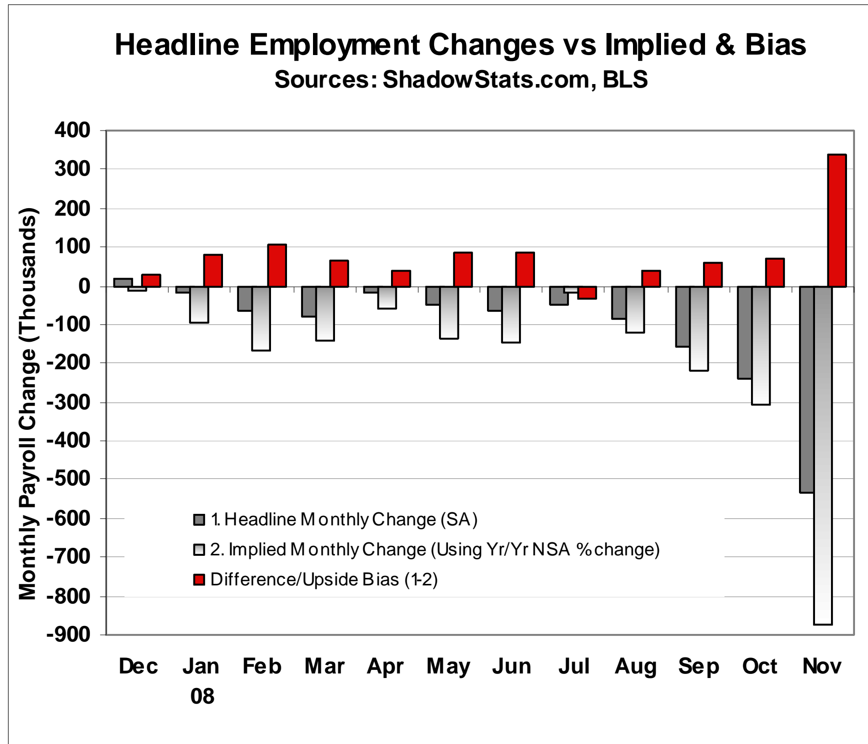
It is worth noting that shy of the Concurrent Seasonal Factor Bias (also graphed), which has been increasing in recent monthly headline reports of payrolls, the annual payroll contraction reflected in the annual-change graph already might be in the range of the earlier severe recessions (see the Employment comments in the Reporting Section).


Housing Starts (3-Month Moving Average)
Through Nov 2008, SA Yr-to-Yr % Change, Source: SGS, St. Louis Fed
100%
80%
60%
40%
20%
0%
-20%
-40%
-60%
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008


Real Retail Sales (3-Month Moving Average)
Through Nov 2008, SA Yr-to-Yr % Change, Source: SGS, St. Louis Fed
15%
10%
5%
0%
-5%
-10%
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008


Industrial Production
Through Nov 2008, SA Yr-to-Yr % Change, Source: FRB
15%
10%
5%
0%
-5%
-10%
-15%
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008


Nonfarm Payroll Employment
Through Nov 2008, NSA Yr-to-Yr % Change, Source: BLS
6%
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
-4%
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008



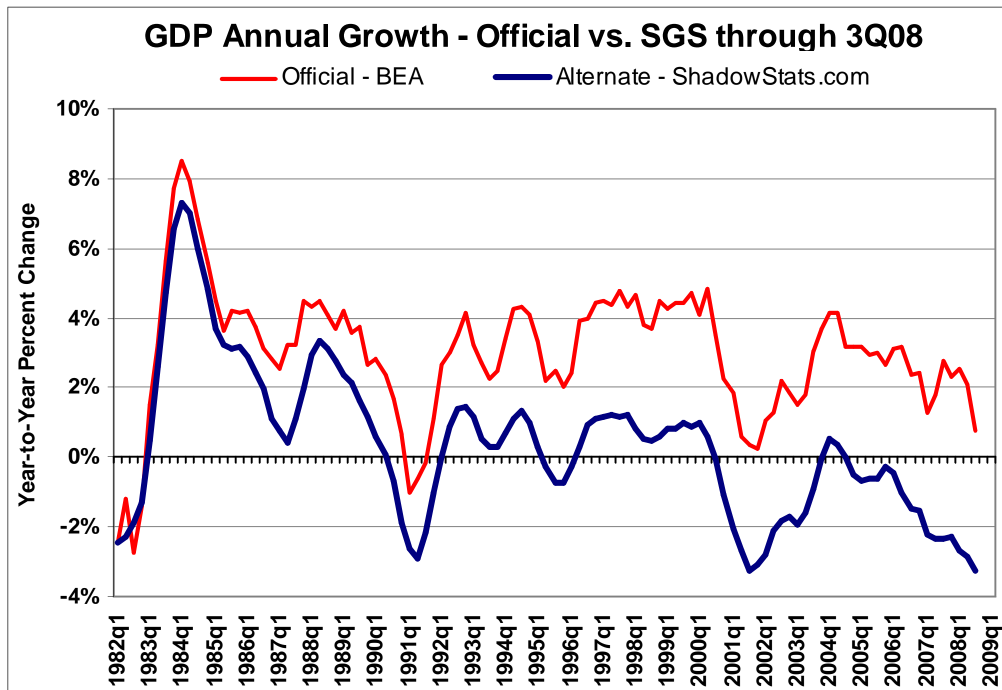
By April, all the indicators graphed should be showing new lows in economic activity. Using various measures, both of the major earlier-period contractions have been touted as the weakest economies since the Great Depression. With extreme duration and extreme contraction in place by April, the current "recession" should take on the title as the "weakest economy" since the Great Depression.

Yesterday's purchasing managers manufacturing survey for the month of December suggests that the mantle already may have been passed. The key index components of production and new orders fell to their lowest levels ever, since January 1948, suggesting the weakest economy since the Great Depression and the production shutdown following World War II. Also, for the fourth quarter, new orders for durable goods are plunging at an annualized rate of 37%.

Using my SGS-Alternate GDP and my definition of depression -- a peak-to-trough contraction in inflation-adjusted economic activity that exceeds 10% -- the current downturn should qualify as a depression in the year ahead. Inflation will pick-up in the same time frame. At such time as hyperinflation kicks in (possibly in 2009), normal commerce would tend to cease, and economic activity would tumble into a great depression, with a peak-to-trough downturn exceeding 25%.

PLEASE NOTE: *A* ***"General background note"*** *provides a broad background paragraph on certain series or concepts. Where the language used in past and subsequent newsletters usually has been or will be identical, month-after-month,* ***any text changes in these sections will be highlighted in bold italics upon first usage.*** *This is designed so that regular readers may avoid re-reading material they have seen before, but where they will have the material available for reference, if so desired.*

Alternate Realities. This section updates the Shadow Government Statistics (SGS) alternate measures of official GDP, unemployment and CPI reporting. When a government economic measure does not match common public experience, it has little use outside of academia or the spin-doctoring rooms of the Federal Reserve, White House and Wall Street. In these alternate measures, the effects of gimmicked methodological changes have been removed from the official series so as to reflect more accurately the common public experience, as embodied by the pre-Reagan-Era CPI and GDP and the pre-Clinton Era unemployment rate. Methodologies for the GDP and CPI series are discussed in the August 2006 SGS.



GDP. The alternate third-quarter 2008 GDP growth reflects the "final" estimate revision, with many of the methodological gimmicks of recent decades removed. The alternate third-quarter inflation-adjusted annual growth rate (year-to-year, as opposed to the popularly-touted annualized quarter-to-quarter rate) for GDP was a decline of roughly 3.3% versus the official year-to-year gain of 0.7%. The official, annualized real quarter-to-quarter change stands at a 0.5% contraction. While the quarterly growth number is popularly followed, its significant inaccuracies are expanded to the fourth-power in reporting. The alternate measure safely would have shown an annualized quarterly contraction in the third quarter, in excess of two-percent.

General background note: Historical data on both the official and SGS-Alternate GDP series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate GDP numbers tend to show deeper and more protracted recessions than have been reported formally or reflected in related official reporting. Nonetheless, the patterns shown in the alternate data are broadly consistent with the payroll employment and industrial production series, which are major indicators used by the National Bureau of Economic Research in determining the official timing of U.S. business cycles.

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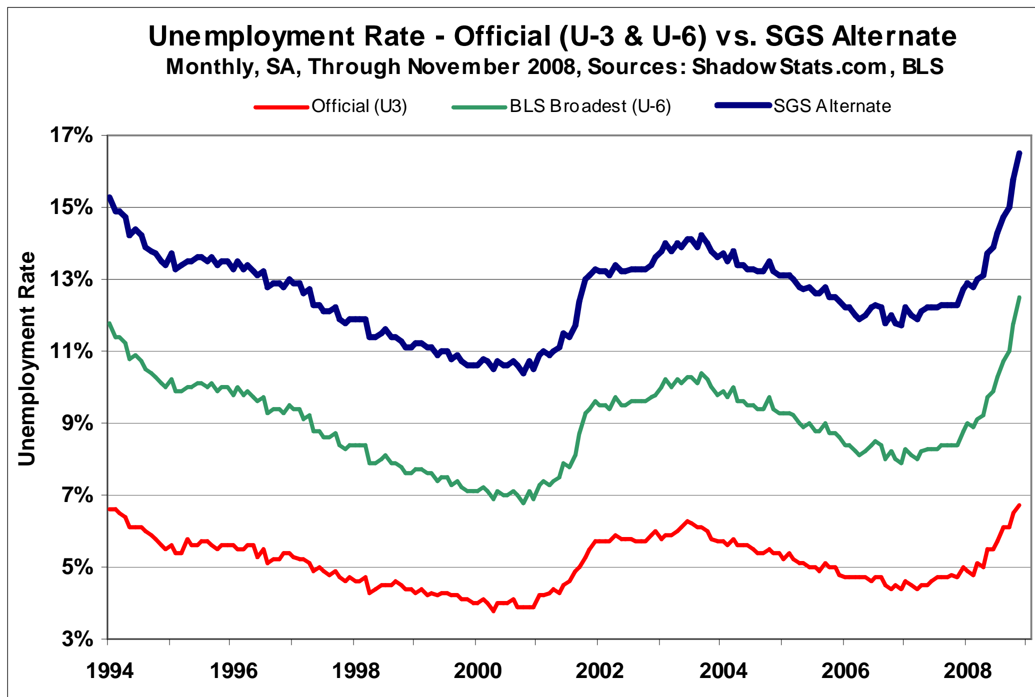


***Unemployment Rate*.** Shown are two official seasonally-adjusted unemployment measures, U.3 and U.6, and the SGS-Alternate Unemployment Measure. The various measures moved sharply higher again in November, reflecting rapidly deteriorating labor-market conditions. The November rates stood respectively at 6.7%, 12.5% and 16.5%, up from 6.5%, 11.8% and 15.8% in October.

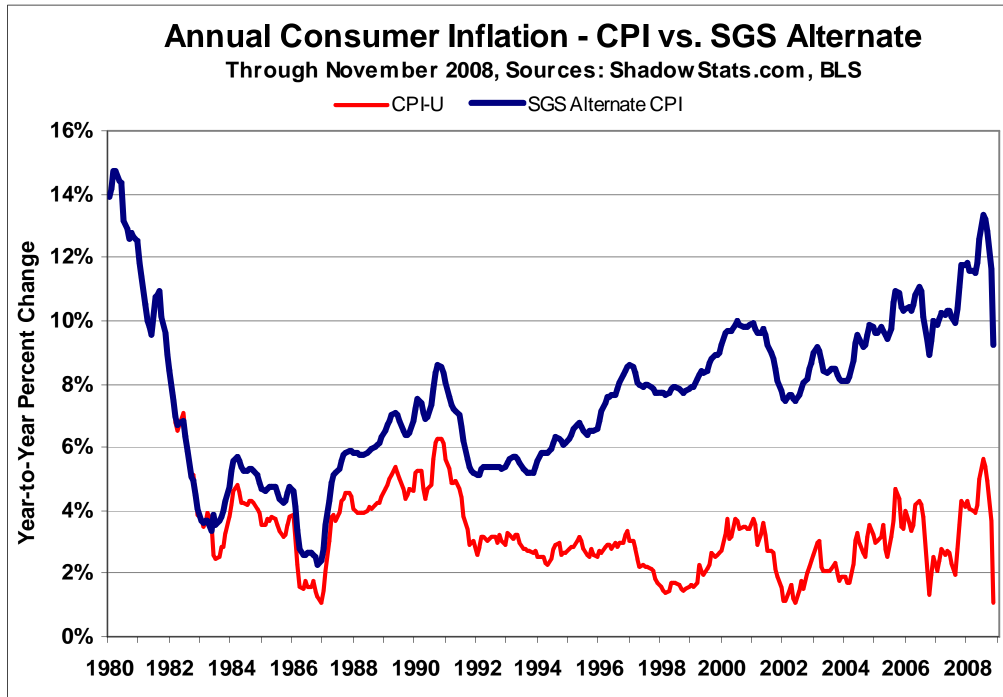
General background note: U.3 is the popularly followed unemployment rate published by the Bureau of Labor Statistics (BLS), while U.6 is the broadest unemployment measure published by the BLS. U.6 is defined as total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers. Marginally attached workers include the discouraged workers who survived redefinition during the Clinton Administration. The SGS-Alternate Unemployment Measure simply is U.6 adjusted for an estimate of the millions of discouraged workers defined away during the Clinton Administration -- those who had been "discouraged" for more than one year.

General background note: Historical data on both the official and SGS-Alternate unemployment series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate numbers are reported from the 1994 series redefinitions forward. It is planned to take the alternate series further back in time.

CPI. Absorbing continued sharp declines in energy prices, November's annual full inflation rates eased sharply, while "core" inflation softened as well. Curiously, the PCE Deflator (I.4 in the accompanying table), which tends to track closely with the C-CPI-U (I.5), showed annual inflation easing from 3.2% in October to 1.4% in November, while the C-CPI-U dropped from 3.3% to 0.7%. Such is suggestive of conflicting issues in handling the energy cost decline in the government's various inflation measures.

Shy of the upcoming, further energy-related battering in December, annual inflation generally should be bottoming out, with much higher inflation seen by mid-2009. Renewed dollar weakness, renewed acceleration in broad money growth and a likely bottoming in energy prices, all should combine with existing inflationary pressures from the ongoing flow-through impact of energy-cost damages still working through the general economy, and from the upside inflation pressures from monetary growth in place before the systemic solvency crisis.

General background note: Historical data on both the official and SGS-Alternate CPI series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate CPI numbers tend to show significantly higher inflation over time, generally reflecting the reversal of hedonic adjustments, geometric weighting and the use of a more traditional approach to measuring housing costs, measures all consistent with the reporting methodology in place as of 1980. Available as a separate tab at the SGS homepage www.shadowstats.com is the SGS Inflation Calculator that calculates the impact of inflation between any two months, 1913 to date, based on both the official CPI-U and the SGS-Alternate CPI series.



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Eight Levels of Consumer Inflation
Annual Inflation for August to November 2008

Measure		Aug	Sep	Oct	Nov
I.1	Core PCE Deflator (r)	2.4%	2.3%	2.0%	1.9%
I.2	Core Chained-CPI-U	2.2%	2.2%	1.9%	1.6%
I.3	Core CPI-U	2.5%	2.5%	2.2%	2.0%
I.4	PCE Deflator (r)	4.4%	4.1%	3.2%	1.4%
I.5	Chained-CPI-U	4.7%	4.3%	3.3%	0.7%
I.6	CPI-U	5.4%	4.9%	3.7%	1.0%
I.7	Pre-Clinton CPI-U	8.7%	8.3%	6.9%	4.4%
I.8	SGS Alternate Consumer Inflation	13.2%	12.9%	11.6%	9.3%

(r) Revised.
Notes: I.1 to I.3 reflect the core inflation rates, respectively, of the substitution-based personal consumption expenditure (PCE) deflator, the Chained-CPI-U and the geometrically-weighted CPI-U. I.4 to I.6 are the same measures with energy and food inflation included. The CPI-U (I.6) is the measure popularly followed by the financial press, when the media are not hyping core inflation. I.7 is the CPI-U with the effects of geometric weighting (Pre-Clinton Era as estimated by SGS) reversed. This is the top series in the CPI graph on the SGS home page www.shadowstats.com. I.8 reflects the SGS Alternate Consumer Inflation measure, which reverses the methodological gimmicks of the last 25 years or so, plus an adjustment for the portion of Clinton-Era geometric weighting that is not otherwise accounted for in BLS historic bookkeeping.

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MARKETS PERSPECTIVE

Extreme volatility became the norm for most markets in 2008, as the U.S. systemic solvency crisis triggered the worst financial panic since the period surrounding and including the Great Depression in

Closing Financial-Market Indicators as of December 31, 2008

Indicator	*4th-Quarter/Year-End 2008*			*3rd-Quarter 2008*			*Year-End 2007*	
	Level	*Qtr/Qtr*	*Yr/Yr*	*Level*	*Qtr/Qtr*	*Yr/Yr*	*Level*	*Yr/Yr*
Equity Market								
DJIA	**8,776.39**	-19.12%	-33.84%	**10,850.66**	-4.40%	-21.39%	**13,264.82**	6.43%
S&P 500	**903.25**	-22.45%	-38.49%	**1,164.74**	-9.00%	-23.71%	**1,468.36**	3.53%
DJ Wilshire 5000	**9,087.17**	-23.48%	-38.68%	**11,875.40**	-9.16%	-22.70%	**14,819.60**	3.94%
NASDAQ Comp	**1,577.03**	-24.61%	-40.54%	**2,091.88**	-8.77%	-22.57%	**2,652.28**	9.81%
Credit Market (1)								
Fed Funds (2)	**0.00%**	-200bp	-425bp	**2.00%**	0p	-275bp	**4.25%**	-100bp
3-Mo T-Bill	**0.11%**	-87bp	-325bp	**0.92%**	-98bp	-290bp	**3.36%**	-166bp
2-Yr T-Note	**0.76%**	-124bp	-229bp	**2.00%**	-63bp	-197bp	**3.05%**	-177bp
5-Yr T-Note	**1.55%**	-143bp	-190bp	**2.98%**	-36bp	-125bp	**3.45%**	-125bp
10-Yr T-Note	**2.25%**	-160bp	-179bp	**3.85%**	-14bp	-74bp	**4.04%**	-67bp
30-Yr T-Bond	**2.69%**	-162bp	-176bp	**4.31%**	-22bp	-52bp	**4.45%**	-36bp
Oil (3) *US$ per Barrel*								
West Texas Int.	**44.60**	-55.68%	-53.55%	**100.64**	-28.11%	23.23%	**96.01**	57.24%
Currencies/Dollar Indices (4) *US$/Unit*								
Pound Sterling	**1.4619**	-17.89%	-26.33%	**1.7804**	-10.56%	-12.68%	**1.9843**	1.31%
Euro	**1.3919**	-1.15%	-4.68%	**1.4081**	-10.59%	-0.97%	**1.4603**	10.65%
Swiss Franc	**0.9369**	4.83%	6.14%	**0.8937**	-8.82%	4.32%	**0.8827**	7.64%
Yen	**0.0110**	16.68%	23.04%	**0.0094**	0.22%	8.52%	**0.0090**	6.54%
Canadian Dollar	**0.8170**	-13.43%	-19.27%	**0.9437**	-3.88%	-6.02%	**1.0120**	17.92%
Australian Dollar	**0.6983**	-11.65%	-20.43%	**0.7904**	-17.34%	-10.74%	**0.8776**	11.31%
Weighted Currency Units/US$ (Jan. 1985 = 100)								
Financial (FWD)	**52.49**	5.93%	11.07%	**49.55**	10.33%	4.93%	**47.26**	-7.64%
Change US$/FX	**--**	-5.60%	-9.96%	**--**	-9.36%	-4.70%	**--**	8.27%
Trade (TWD)	**57.15**	4.33%	8.40%	**54.78**	7.29%	2.34%	**52.72**	-10.00%
Change US$/FX	**--**	-4.15%	-7.75%	**--**	-6.79%	-2.28%	**--**	10.01%
Precious Metals (5) *US$ per Troy Ounce*								
Gold	**869.75**	-1.67%	4.32%	**884.50**	-4.92%	19.04%	**833.75**	31.92%
Silver	**10.79**	-16.74%	-26.90%	**12.96**	-26.57%	-5.06%	**14.76**	14.41%

bp: Basis point or 0.01%. (1) Treasuries are constant-maturity yield, U.S. Treasury. (2) Current Fed Funds target is 0.00% to 0.25%. (3) Department of Energy. (4) Shadow Government Statistics, Federal Reserve Board (see Dollar Index Section for definitions). (5) London afternoon fix, Kitco.com.

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the 1930s. While the crises continue, and while extreme volatility may be dormant temporarily, almost anything can happen in the current circumstance.

I continue to argue that investors should be looking at the long-term and at preserving their wealth and assets in what eventually will become a hyperinflationary great depression. With severe economic, inflation and currency displacements ahead in the United States, those who can ride out the turmoil, eventually, should see tremendous investment opportunities. As to preserving capital and assets for someone in a U.S. dollar-denominated environment, holding some assets in physical gold (and some silver) and holding some assets outside the dollar (i.e. Swiss franc) in high-quality, liquid assets remains my best thinking. Again, this is for the long-term. Short-term conditions still can show extreme volatility in the U.S. dollar and precious metals as seen in the last year. Putting aside risks of political instabilities tied to the economic turmoil or any short-term liquidity concerns, real estate also remains a prime long-term hedge against the severe currency debasement that lies ahead.

Looking beyond the summary statistics in the preceding table, consider that in the two-year period from December 31, 2006 to December 31, 2008, gold gained 37.6%, the Swiss franc gained 14.3%, and the Dow Jones Industrial Average fell by 29.6%. Two years ahead, I would expect to see similar direction on the mentioned assets (using an inflation-adjusted DJIA), but with greater percentage movements.

General background note: The broad outlook is ***little changed***, with ***ongoing*** crises in systemic solvency and in a deepening inflationary recession. Over the long-term: U.S. equities will continue to suffer in a severe bear market; long-term U.S. Treasury yields will spike in response to inflation, eventual dollar dumping and mounting Treasury borrowing needs against a market with weakening demand; selling will intensify against the U.S. dollar, evolving into dollar dumping and dumping of dollar denominated assets. Precious metals, particularly gold, will rally against mounting monetary and inflation pressures (***and likely higher oil prices from a weakening dollar***), weakness in the dollar, and as safe-havens against increasing systemic instability. Holding gold and holding assets outside the U.S. dollar (such as in the Swiss franc and the Canadian dollar) remain the best long-range hedges against all the real risks facing investors and the system.

U.S. Equities -- At year-end 2008, from their all-time closing high levels of August 2007, the DJIA was down by 38.04%, the S&P 500 was down by 42.29%, the Dow Jones Wilshire 5000 was down by 42.56%, and the NASDAQ Composite was down by 44.84%. This bear market has been savage, but likely it is not over, with the potential of roughly an 80% loss from current levels, which would bring total losses -- peak-to-trough -- into the 90% range as seen in the 1929 to 1933 period.

Downside movement in the equity markets is not continuous. There often are intervening sharp rallies with the sell-offs, as was seen in the 1929 to 1933 period. The 1929 high in the DJIA was not recovered in 1955.

Promising an ongoing bear market, the economy faces a deepening recession/depression with no sustainable economic recovery in sight. Even with a big stimulus package, the economy faces at best some bottom-bouncing before its next downleg. Also, with heavy dollar selling, renewed inflation and mounting issues as to the long-term quality of U.S. Treasuries, long-term interest rates eventually will rise sharply.

Barring the Federal Reserve or the U.S. Treasury entering the equity markets as a buyer of last resort, stocks have entered a particularly protracted and savage bear market that still has a long way to run. Equities have begun to catch-up with the underlying economic, financial and systemic fundamentals, but the aggregate downside adjustments to stock prices still should be quite large over a number of years, eventually

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rivaling the total 90% decline in equities seen in the 1929 crash and ensuing four years. The current decline might have to be measured in real terms, however, as a hyperinflation eventually will kick in, with the Fed moving to liquefy the system and monetize federal debt. Stocks do tend to follow inflation, since revenues and earnings get denominated in inflated dollars. Hence with a hyperinflation, a DJIA of 100,000 or 100,000,000 could be expected, but such still would be well below today's levels, adjusted for inflation (see the *Hyperinflation Special Report* of April 8, 2008).

U.S. Credit Market -- The Federal Reserve has cut the targeted fed funds rate to 0.00% to 0.25%, as low as it can go. U.S. Treasury yields already are at or near historic lows and are not sustainable at those levels. Accordingly, interest rates eventually and generally should head higher from here, with long rates spiking sharply. Promising higher yields will be renewed inflation, mounting problems with the U.S. dollar and concerns as to U.S. government solvency.

Yields were driven lower by direct intervention and by flight-to-safety during one of the great financial panics of all time, despite ongoing heavy borrowing by the U.S. Treasury and Federal Reserve efforts to debase the U.S. dollar significantly. The debasement efforts are beginning to work and should become a major factor in the markets in the year ahead. If inflation rises strongly in the year ahead, as I expect (but not at hyperinflationary levels), it would tend to support double-digit long-term yields.

U.S. Dollar -- Central bank intervention and the last eight-to-nine months of systemic and financial turmoil reversed much of the dollar selling seen over the preceding year, running counter to significantly negative U.S. dollar fundamentals. A more-stable system in the last several weeks and a bottoming of growth in the broad money supply, however, have been accompanied by periods of significant renewed selling of the U.S. dollar. For the year, though, of the major Western currencies, only the Japanese yen and Swiss franc gained on the greenback.

In terms of underlying fundamentals for the U.S. dollar, little has changed: they remain abysmal and are deteriorating. Accordingly, as the global financial system shows early signs of stability, heavy selling of the U.S. dollar has started anew, albeit still sporadic. The long-term outlook for the dollar remains for a massive sell-off, with flight from the dollar eventually evolving into a flight to safety outside the dollar.

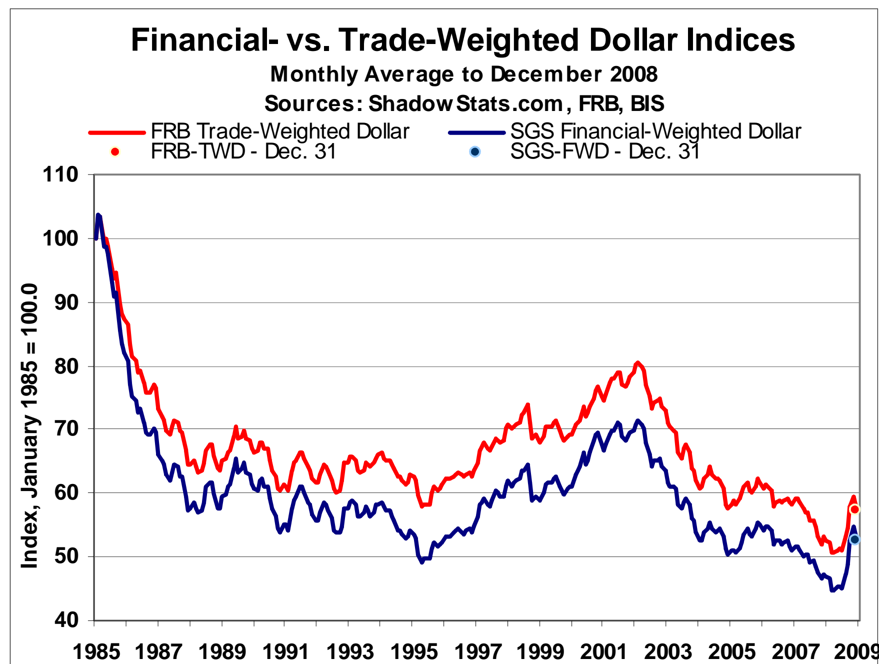
The U.S. dollar's portfolio of underlying fundamentals generally could not be much worse. Relative to major trading partners, the U.S. economy is much weaker; interest rates are lower; inflation has been and will be higher, although the December CPI will take another oil-price related downside hit; fiscal and monetary conditions are worse in the extreme; relative trade-balance conditions are horrendous; and relative political/systemic concerns are high, although the incoming Obama Administration likely will enjoy some grace period with markets.

Deteriorating in the fundamentals, whatever limited U.S. fiscal and monetary discipline existed is gone. The U.S. is moving quickly to debase its currency in a manner unprecedented for the world's reserve currency. The U.S. economy also is in much worse shape than previously recognized by the rest of the world, sinking rapidly, and it is relatively much worse off than its major trading partners.

The proximal trigger for a full dollar panic already may be in place, given the Fed and Treasury's responses to the ongoing systemic solvency crisis. Otherwise it could come from a particularly bad economic statistic, political missteps by the current or incoming Administration, negative trade or market developments outside the United States, or a terrorist attack or expansion of U.S. military activity. When the trigger is pulled, what likely will be broad selling pressure will turn into an outright panicked dumping of the greenback,

which should overwhelm any short-lived central bank intervention and roil the domestic financial markets, further. Generally, the greater the magnitude of the dollar selling, the greater will be the ultimate inflation pressure and liquidity squeeze in the U.S. capital markets, on top of an otherwise ongoing systemic and intensifying economic crisis.

As shown in the accompanying graph, the sharp rally in the U.S. dollar, since the market distortions and interventions following the Bear Stearns crisis, may be close to having run its course. The financial- and trade-weighted indices have fallen back in the last month, with the latest data points shown for the indices as of year-end 2008.



U.S. Dollar Indices. The Shadow Government Statistics' Financial-Weighted U.S. Dollar Index (FWD) is based on dollar exchange rates weighted for respective global currency trading volumes. For December 2008 the FWD fell by 2.41% for the month after a gain of 4.28% in November. The December 2008 monthly average index level of 53.41 (base month of January 1985 = 100.00) still was up by 12.84% from December 2007, but such slowed from November's 17.73% annual gain. As of December 31st, the FWD stood at 52.49.

Also falling in December was the Federal Reserve's Major Currency Trade-Weighted U.S. Dollar Index (TWD). The December 2008 average declined by 2.47% from November, which, in turn, was up by 2.87% from October. The December 2008 index level of 58.06 (base month of January 1985 = 100.00) was up by 9.49% from December 2007, versus an annual 12.84% increase in November. As of December 31st, the TWD closed at 57.15.

The differences in the two series can be accounted for largely by the much heavier weighting of the Canadian dollar in the TWD series.

General background note: Historical data on both dollar series are available for download on the

Alternate Data page of www.shadowstats.com. See the July 2005 SGS Newsletter for methodology.

Gold and Silver -- Although gold closed up slightly for the year, both gold and silver were pummeled from their historic or multi-year highs seen in March. Beyond some normal profit taking, the non-fundamentally driven rally in the U.S. dollar, central bank manipulations, and forced liquidations of gold to raise cash for troubled institutions, there were no solid fundamentals for the collapse in precious metals that followed the Bear Stearns bailout in mid-March.

Falling from its all-time high London afternoon fix of $1,011.25 per troy ounce on March 17th, amidst extreme volatility, gold hit a subsequent bottom of $712.50 in October. It closed December 30th at $869.75. In like manner, silver plunged from its March 17th high of $20.92 per troy ounce, hitting a subsequent low close of to $8.88 in October. It closed on December 31st at $10.79.

For December (per Kitco.com for both and silver prices), the monthly average London gold afternoon fix was $816.09 per troy ounce, up from $760.86 in November, but still well shy of the historic monthly-average high of $948.43 hit in March. For the year, the average price of gold was $871.96, up from $695.39 in 2007, and up from $603.46 in 2006.

Silver averaged $10.29 per troy ounce in December, up from $9.87 in November, and still well off the monthly-average high for the year of $19.51 in March. For the year, the average price of silver was $14.99 per troy ounce, up from $13.38 in 2007 and up from $11.55 in 2006.

Since the turmoil following the Bear Stearns machinations, the fundamentals actually have gotten stronger for gold as both an inflation hedge and as a safe-haven store of wealth. Where the recent strength in the U.S. dollar likely was the major factor in the recent weakness of the prices for precious metals and oil, those pressures should reverse, as nascent U.S. dollar selling intensifies. Deteriorating global political conditions, a looming major new inflation scare, and rapidly deteriorating U.S. fiscal and monetary conditions all promise extreme upside potential for gold and silver prices over the long haul.

When the dollar turns meaningfully to the downside -- and that process may have begun -- gold prices should rebound sharply and could regain $1,000 fairly quickly.

Inflation-Adjusted Historic Gold and Silver Highs. Outside of the current period's March 17th high of $1,011.25, the earlier all-time high of $850.00 (London afternoon fix, per kitco.com) of January 21, 1980 still has not been hit in terms of inflation-adjusted dollars. Based on inflation through November 2008, the 1980 gold price peak would be $2,321 per troy ounce, based on not-seasonally-adjusted-CPI-adjusted dollars, and would be $6,640 per troy ounce in terms of SGS-Alternate-CPI-adjusted dollars.

In like manner, the all-time high price for silver in January 1980 of $49.45 (London afternoon fix, per silver institute.org) has not been hit since, including in terms of inflation-adjusted dollars. Based on inflation through November 2008, the 1980 silver price peak would be $135 per troy ounce, based on not-seasonally-adjusted-CPI-adjusted dollars, and would be $386 per troy ounce in terms of SGS-Alternate-CPI-adjusted dollars.

General background note: As discussed in the *Hyperinflation Special Report (April 2008)*, the eventual collapse of the U.S. dollar -- the world's reserve currency -- will force the creation of a new international currency system. Gold likely will be structured into any replacement system, in an effort by those organizing the new currency structure to gain public acceptance.

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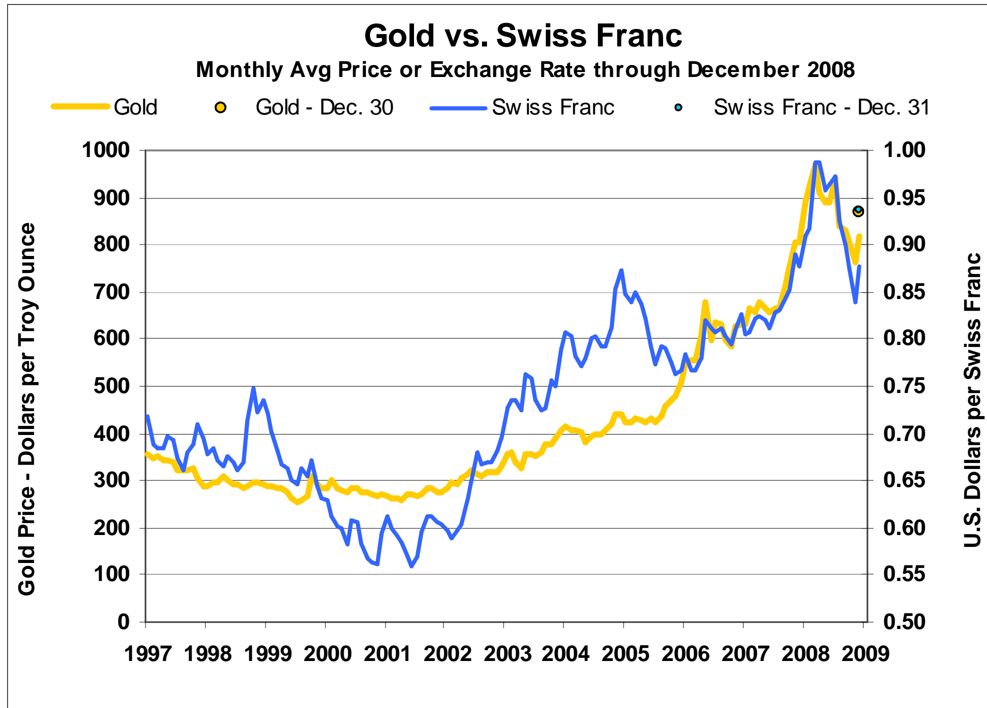
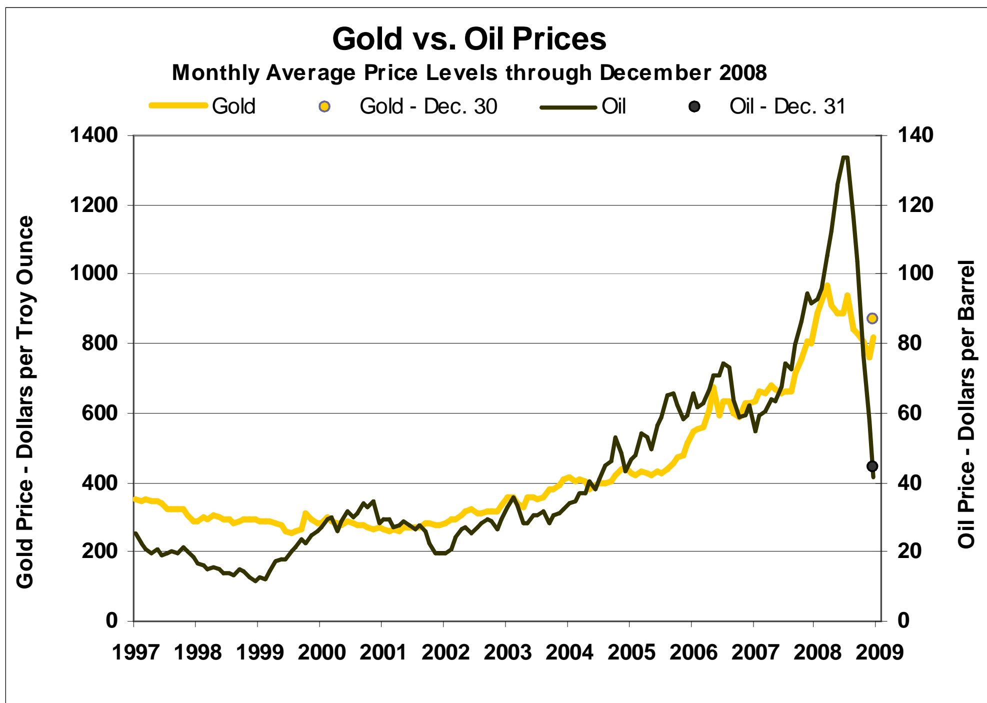
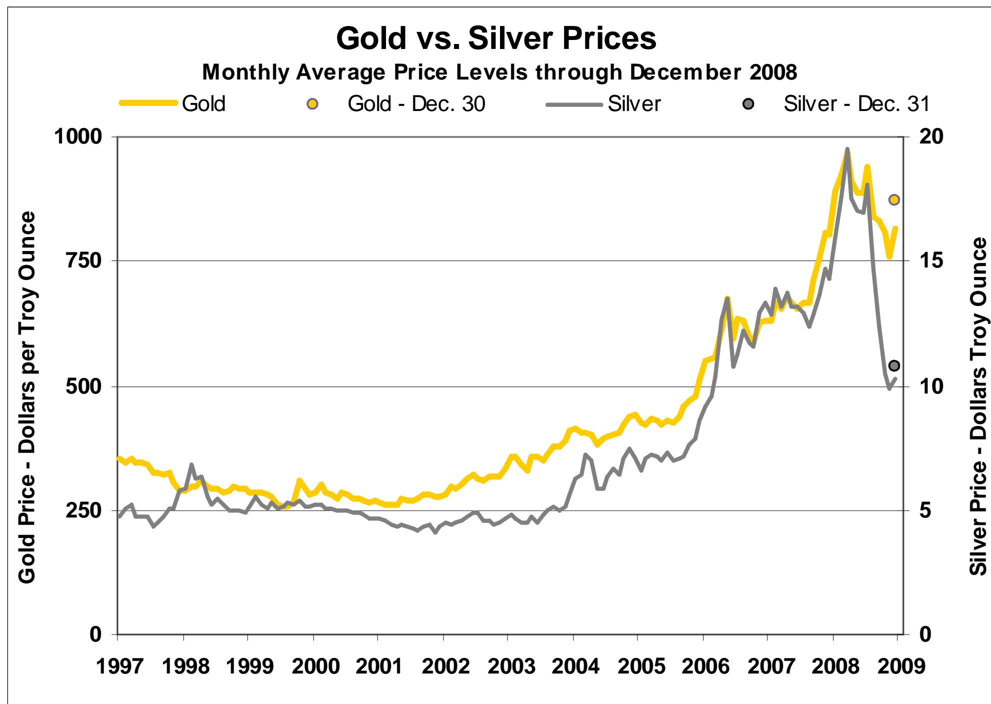
The updated gold versus oil, Swiss franc and silver graphs show December monthly average price levels, as well as added points for closing prices at year-end, with gold at $869.75, silver at $10.79, oil at $44.60 and the Fed's published noon buying rate for the Swiss franc at $0.9369. As current market distortions subside, all four measures should trade significantly higher in the months ahead, eventually breaking the highs seen otherwise during 2008.






Gold vs. Silver Prices
Monthly Average Price Levels through December 2008
Gold
Gold - Dec. 30
Silver
Silver - Dec. 31
Gold Price - Dollars per Troy Ounce
Silver Price - Dollars Troy Ounce
1000
750
500
250
0
20
15
10
5
0
1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009

REPORTING PERSPECTIVE

The Big Three Market Movers

Underlying economic fundamentals have continued showing unusually sharp deterioration in recent reporting, with a downside acceleration and ongoing catch-up seen particularly in post-election payroll reporting. With election pressures gone, and with the markets acknowledging a bad recession, reporting pressures could shift to the downside for a short while, reflecting ongoing catch-up, and the need for the incoming Obama Administration to sell its stimulus package. Such also could be used to set a low base against which future Obama-generated activity can be measured. Suggestions here of possible of games-playing with the numbers have nothing to do with Mr. Obama, per se. It comes only from the historical precedent of such happening in nearly all post-Truman administrations, and from the preponderance of Clinton Administration people showing up in Washington. The Clinton Administration was the most masterful of all in controlling its reported data.

In the other direction, Messrs. Bernanke and Paulson /Geithner need a stable or relatively strong U.S. dollar in the still-evolving systemic solvency crisis, and such requires contained inflation numbers and stronger economic data than might be expected in the now recognized recession. With the financial crisis remaining a threat to national security, almost anything remains possible in the arena of data and market manipulations. Data manipulation is an extremely inexpensive and effective policy tool, but its use presumably depends to certain degree on perceived financial market vulnerability.

Absent manipulation, and against market expectations that are shifting sharply to the downside, most near-term economic reporting still should tend to surprise the markets on the downside. With inflation expectations having tanked along with oil prices, beyond the pending December CPI report, most inflation reporting should surprise expectations on the upside.

Employment/Unemployment -- As discussed in the December 5th *Flash Update*, and as explored and graphed in the Opening Comments, payroll employment likely is sinking faster than has been reported by the Bureau of Labor Statistics (BLS) and shortly should be showing the sharpest annual percentage decline in annual employment change since the shutdown of war production at the end of World War II and the Great Depression. Such a pace of tumbling already may be in place, but it is not showing, due at least partially to the Concurrent Seasonal Factor Bias (CSFB) discussed below.

As bad as the headline November jobs numbers appeared to have been, the data indicated that consistent reporting would have shown an even bleaker picture. Perhaps someone in the incoming Congress or Administration might raise a question with the BLS as to the nature of the increasingly obvious positive biases built into the monthly headline payroll numbers. The problem is evidenced by ongoing massive revisions to prior history (exceeding the 95% statistical confidence interval for monthly change), after the markets have absorbed much happier headline numbers published in the months before, as well as by the consistent, overly positive nature of the headline jobs numbers confirmed by the CSFB.

For example, the pre-election headline estimate of September payrolls was a decline of 159,000 +/- 129,000, but the CSFB suggested the reporting

should have been a decline of about 219,000. In the first post-election revision, September's decline deepened to 284,000; in the second revision, it dropped to a decline of 403,000. October's headline jobs loss was 240,000, while the CSFB suggested it should have been about 308,000. October's jobs loss revised to 320,000 in the first revision. The headline November jobs loss was 533,000, but the CSFB suggested it should have been a loss of about 873,000.

Payroll Survey. The BLS reported a statistically-significant, seasonally-adjusted jobs loss of 533,000 (down 732,000 net of revisions) +/- 129,000 for November, following a revised 320,000 (previously 240,000) jobs loss in October. Annual contraction (unadjusted) in total nonfarm payrolls continued to deepen, down 1.47% in November, versus a revised 0.79% (previously 0.85%) decline in October. The seasonally-adjusted series also contracted year-to-year, down by 1.35% in November, versus a decline of 0.93% (previously) 0.78% in October.

Concurrent Seasonal Factor Bias. The pattern of impossible biases (see the Reporting/Market Focus in *SGS Newsletter No. 43* of June 10, 2008) being built into the headline monthly payroll employment changes intensified sharply with November reporting. Instead of the headline jobs loss of 533,000, consistent application of seasonal-adjustment factors -- net of what I call the concurrent seasonal adjustment bias -- would have shown a more-severe monthly jobs loss of about 873,000. This upside reporting bias has been seen in 11 of the last 12 months, with a rolling 12-month total upside headline-number bias of 955,000.

Birth-Death/Bias Factor Adjustment. A minor element that added upside pressure to the latest payroll number was the monthly bias factor (birth-death model). Never designed to handle the downside pressures from a recession, the model added a 30,000 upside jobs bias to November 2008 (versus an upside bias of 17,000 in November 2007), and followed a net upside bias of 71,000 jobs in October 2008. The process boosted financial-activities by 5,000, but subtracted 7,000 from construction. The largest benefactor was the trade, transportation and utilities sector, which picked up an extra 17,000 jobs. Although the adjustments are made to the unadjusted series, they flow through at roughly the same magnitude in the seasonally-adjusted series.

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 673,000 in November, following a 297,000 decline in October.

The November 2008 seasonally-adjusted U.3 unemployment rate showed a statistically-insignificant increase to 6.68% +/- 0.23% from 6.50% in October. Unadjusted U.3 rose to 6.5% in November, versus 6.1% in October. The broader November U.6 unemployment rate jumped to an adjusted 12.5% (12.2% unadjusted) from 11.8% (11.1% unadjusted) in October.

During the Clinton Administration, "discouraged workers" -- those had given up looking for a job because there were no jobs to be had -- were redefined so as to be counted only if they had been "discouraged" for less than a year. This time qualification defined away the bulk of the discouraged workers. Adding them back into the total unemployed, actual unemployment, as estimated by the SGS-Alternate Unemployment Measure (graphed in the Alternate Realities section), rose to 16.5% in November from 15.8% in October.

Note of Caution. Keep in mind that any comments in the popular media as to historical comparisons of current unemployment data to 1994, are going against the first month published in most of the current series. Accordingly, any reference to the "worst level since 1994," could

well be against a much earlier period, if only the data were comparable.

Comparisons of current reporting with data before 1994 are not valid. In 1994, the BLS completely redesigned and redefined the unemployment series and all its measures, broad and narrow, so that the new series going forward could not be compared with the old series. I still am struggling to take my alternate measure back before 1994, where finding consistent and good data is a major problem. That said, the U.6 broad measure of 12.5% unemployment was the highest since before January 1994.

Employment Environment. The broad deterioration in November's employment environment broadly was in line with the better-quality employment-environment indicators: October/November help-wanted advertising levels were at an historic low; new claims for unemployment insurance continued to surge sharply in terms of annual growth; and deepening, recession-level employment readings continued in both the December/November manufacturing and November nonmanufacturing purchasing managers survey. Since the employment and unemployment indicators tend to be coincident markers of broad economic activity, weaknesses in these numbers are signaling an ongoing and deepening recession in place.

Next Release (January 9th): Based on continuing deterioration in underlying economic activity, the December payroll survey should plunge again, by more than 400,000 jobs, along with a further spike in the unemployment rate. Consensus expectations (briefing.com) are for a decline of about 475,000, with a 0.3 percentage point increase in the unemployment rate. While not unreasonable, the expected weak results likely still are shy of reality.

Gross Domestic Product (GDP) -- As discussed in the December 23rd *Flash Update*, the Bureau of Economic Analysis's (BEA) "final" estimate revision (it gets revised again in July 2009) of real (inflation-adjusted) annualized growth in the third-quarter GDP remained a statistically insignificant contraction of 0.51% +/- 3% (95% confidence interval), unchanged from the "preliminary" estimate, but deeper than the "advance" estimate of a 0.25% annualized decline. That calculation, however, reflected a combination of an upward revision to nominal (not adjusted for inflation) annualized growth of 3.57%, from a preliminary 3.35%, and an offsetting upwards revision to GDP inflation (implicit price deflator) to 4.11% from a preliminary 3.88%.

The third quarter's contraction of 0.51% was against a second quarter growth rate of 2.83%. In terms of year-to-year change, the third quarter's annual growth revised to 0.75% (previously 0.74%), against second quarter annual growth of 2.05%. The SGS-Alternate GDP estimate remained an annual contraction of roughly 3.3% versus an annual (not annualized) contraction of 2.9% in the second quarter. Against reporting of underlying economic series, an annualized quarterly contraction in excess of 2% for the third quarter would have been more realistic than the 0.51% estimate.

The BEA's GDP-like measures for third-quarter 2008 also were revised in the latest reporting: 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.

GNP. Third-quarter GNP contracted at an annualized rate of 0.17% (previously 0.43%), versus a 2.10% gain in the second quarter. Year-to-year change was 0.83% (previously 0.77%) in the third-quarter, versus 2.43%, in the second.

GDI. Third-quarter GNP contracted at an annualized rate of 0.57% (previously 0.56%), versus a 0.46% gain in the second quarter, but the current contraction was the third quarterly

contraction in the last four quarters. Year-to-year change was a contraction of 0.45% (previously 0.43%) in the third quarter, following a 0.30% annual gain in the second.

4th-Quarter GDP. Looking to the "advance" estimate of fourth-quarter GDP on January 30, 2009 -- the first estimate due to be published by the incoming Obama Administration (although the bulk of the data will be prepared under the Bush Administration) -- some forecasts being floated in the markets are for a 5% annualized real contraction. Such is not an unreasonable number and even might be desirable as a political tool in helping to sell the promised massive stimulus package. Any contraction deeper than an annualized 3% would turn year-to-year GDP change negative, a reality already indicated by most of the better underlying economic series.

Less-negative numbers then would tend to be reported in the post-stimulus period. In order to get a real 5% annualized contraction in fourth-quarter 2008, though, nominal growth likely would have to turn negative as well, a characteristic of only the deepest historical downturns.

Given the recent collapse in energy prices, the fourth-quarter GDP implicit price deflator's inflation rate should be lower than the 4.11% used in the third quarter. (GDP inflation subtracted from nominal GDP growth yields real GDP growth.) The importation of lower-priced oil in the fourth-quarter should work as an inflation booster (imports are subtracted from economic activity, which reverses the inflation impact in the GDP), offsetting some of the impact of lower prices of consumed gasoline, etc., so the annualized pace of slowing GDP inflation should not be quite as severe as seen in the CPI. Even so, nominal GDP growth could see its sharpest annualized decline since the Eisenhower Administration.

Next Release (January 30): Underlying economic fundamentals suggest that the "advance" estimate of fourth-quarter 2008 GDP should show a deeper annualized contraction than was reported in the third quarter. Whatever is reported likely will be near the consensus estimate of the time, as that often is targeted in the "advance" reporting by the BEA. As discussed above, look for annual real GDP change to turn negative, as well as for a possible quarterly contraction in nominal GDP.

Consumer Price Index (CPI) -- As discussed in the December 16th *Flash Update*, the sharp hits in November's reported monthly and annual inflation rates were about as expected, due to the continued collapse in oil-related prices, particularly in gasoline. With oil and gasoline prices perhaps near a bottom, however, annual CPI inflation likely is near a bottom, too, and not likely to turn negative in a formal deflation.

CPI-U. The Bureau of Labor Statistics (BLS) reported seasonally-adjusted November CPI-U (I.6) declined by 1.68% (down by 1.92% unadjusted) +/- 0.12% for the month, versus a 0.96% drop (down by 1.01% unadjusted) in October. Year-to-year or annual inflation in November fell to 1.07% in November, from 3.66% in October, still remaining in positive territory. For those of you interested in exploring the various facets of official CPI-U reporting, I continue to refer you to cpiwatch.com, a site prepared by one of my SGS colleagues.

Annual inflation would increase or decrease in December 2008 reporting, dependent on the seasonally-adjusted monthly change versus the 0.36% monthly increase seen in December 2007. The difference in growth would directly add to or subtract from November's annual inflation rate of 1.07%.

With average monthly gasoline prices dropping by roughly another $0.19 per gallon in December (per the Department of Energy), the seasonally adjusted CPI could fall by roughly 0.9%, with annual inflation turning negative by 0.2% to 0.3%. Albeit minimal and likely fleeting, such would

represent formal deflation, the first outright decline in the CPI-U since a 0.4% drop in August 1955. Of course, if the CPI today were calculated the same way it was back then, annual inflation December still would be near 8%, instead of showing a fractional decline (see the Alternate Data Section).

C-CPI-U. Year-to-year or 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 -- also eased sharply, to 0.69% in November, from 3.28% in October. Yet the PCE deflator, which usually tracks the C-CPI closely, slowed only to 1.4%.

Alternate Consumer Inflation Measures. Adjusted to pre-Clinton (1990) methodology (I.7), annual CPI growth eased to roughly 4.4% in November from 6.9% in October, while the SGS-Alternate Consumer Inflation Measure (I.8), which reverses gimmicked changes to official CPI reporting methodologies back to 1980, dropped back to roughly 9.3% in November from 11.6% in October. The alternate numbers are not adjusted for any near-term manipulations of the data. 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 (January 16): The December CPI likely will contract by roughly 0.9% for the month, due primarily to the continued fall in oil and gasoline prices. As discussed above, a formal small annual deflation appears a fair bet, but such should be considered in the context of methodological revisions in the last several decades that have tended to reduce the level of reported CPI inflation.

Annual inflation would increase or decrease in December 2008 reporting, dependent on the seasonally-adjusted monthly change versus the 0.36% monthly increase seen in December 2007. The difference in growth would directly add to or subtract from November's annual inflation rate of 1.07%.

Longer-range impact from renewed dollar weakness, a likely bottoming in oil prices and rising broad money growth will tend to generate some upside CPI surprises in early 2009.

Other Troubled Key Series

Federal Deficit. The federal budget deficit deteriorated sharply in fiscal-year 2008 (year-ended September 30th) and has exploded in the first two months of fiscal-year 2009. As discussed in the Reporting/Market Focus section, unsustainable GAAP-based federal deficits and federal obligation levels also have worsened markedly.

The official 2008 federal deficit was $454.8 billion, against a $161.8 billion deficit in 2007. These are the officially-gimmicked numbers (counting Social Security revenues, but not liabilities, not fully counting the costs of the Iraq War, etc.), using a variation on cash-based accounting, not GAAP reporting. The 2008 GAAP-based deficit (counting unfunded Social Security and Medicare liabilities, etc.), using accrual accounting, was $5.1 trillion, up from $1.2 trillion ($4 trillion-plus, using consistent annual assumptions and accounting) in 2007.

Significantly, the $700 billion financial system bailout package was not enacted until fiscal-year 2009 and thus was not reflected in any of the 2008 numbers. For October and November 2008 -- the first two months of the new fiscal year -- the official deficit more than doubled to $401.6

billion, from $154.1 billion in the same period of fiscal 2008.

Near-term fiscal results reflect the impact of the ongoing solvency crisis and the deepening recession. The 12-month rolling deficit through November 2008 rose to $701.3 billion, up from October's $635.1 billion, and September's $454.8 billion. The 12-month rolling deficit through November 2007 was just $194.2 billion. The fiscal problems likely are going to be exacerbated in the next several months, with the incoming Administration promising to boost government spending significantly, in an effort to stimulate economic activity.

For fiscal 2008, recession-impaired tax revenues fell by 1.7% from 2007, that decline deepened to 3.1% for the 12-month rolling results through November. The downturn in tax revenues tied to the deepening recession also has started to impact state and local government fiscal operations, with serious funding problems surfacing in a number of jurisdictions.

Viewing the change in the level of gross federal debt bypasses several of the regular reporting manipulations of the government's financial results 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 $10.553 trillion at December 30, 2008, down by $128 billion for the month, but up by $1.324 trillion from December 31, 2007, which in turn was up $549 billion from December 2006. Gross federal debt stood at $10.661 trillion at November 30, 2008, up by $86.1 billion for the month and up $1.512 trillion from November 2007, which in turn was up $516 billion from November 2006.

With mounting solvency crisis impact, gross federal debt stood at $10.574 trillion at October 31, 2008, up by an extraordinary $549 billion for the month and up $1.495 trillion from October 2007, which in turn was up $495 billion from October 2006. As of the end of September 2008, the close of the government's fiscal year, gross federal debt stood at $10.025 trillion, up $379 billion for the month and up by $1.017 trillion from September 2007, which in turn was up $501 billion from September 2006.

Initial Claims for Unemployment Insurance -- The ongoing rapid rise in initial claims for unemployment insurance continues to reflect the severe deterioration in labor market conditions. On a smoothed basis for the 17 weeks ended December 27th, annual growth hit 52.1%, up from 46.2% as of the 17 weeks ended November 29th, and up from 39.4% as of the 17 weeks ended October 25th. 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 Christmas -- with a meaningless 98,000 plunge in claims for the December 27th week -- and New Year's 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 primarily the benefit of sharply declining gasoline prices, November's seasonally-adjusted monthly real earnings surged by 2.3% for the month, following a 1.6% monthly increase in October. Annual change in November, accordingly, turned to the plus side, up by 2.2% from the year before. Such followed a 0.8% annual decline in October.

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 still shows the average worker to be under severe financial stress in an ongoing structural recession (see the *Hyperinflation Special Report* of April 8, 2008, and the last newsletter's Reporting Focus).

Retail Sales -- As discussed and graphed in the Opening Comments and discussed in the December 12th *Flash Update*, the Census Bureau reported that seasonally-adjusted sales for the month of November -- the opening month of the holiday shopping season -- fell by 1.76% (by 2.21% net of revisions) +/- 0.6% (95% confidence interval), versus a revised decline of 2.95% (previously 2.77%) in October. The declines, once again, were exacerbated by a fall in gasoline prices, but as indicated in November's "core" measure, they still were significant. The extreme volatility in monthly gasoline prices has been enough to affect levels of consumption. Based on Department of Energy reporting, average gasoline prices in November were down by roughly 30%, versus a not-seasonally-adjusted decline in gasoline station sales of 23.6%, and a seasonally-adjusted 14.7% drop.

On a year-to-year basis, November retail sales (before inflation adjustment) were negative for a third month, down by 7.41%, versus a revised 4.63% (previously 4.11%) decline in October.

Real Retail Sales. Real (inflation-adjusted) November retail sales fell by 0.08% on a monthly basis, versus a 2.01% contraction in October, deflated using the CPI-U. Annual real retail sales fell by 8.33% in November versus 8.00% in October, while the annual contractions on a three-month moving-average basis were 7.47% and 5.99%, respectively, in November and October.

The inflation-adjusted retail sales series tends to lead activity in the broad economy. The patterns of declining monthly, quarterly and annual real retail sales remain consistent with a deepening recession and are not yielding any hint or sign of a pending economic bottom or upturn.

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 0.30% (down 0.81% net of revisions) in November, following a revised 1.82% (previously 1.65%) decline in October. Those numbers contrasted with the official aggregate drop of 1.76% in November and the revised 2.95% in October. On an annual basis, November "core" retail sales fell by 6.92%, versus a revised 6.53% (was 5.95%) decline in October.

Next Release (January 14): December retail sales should continue showing a pattern of deepening monthly and annual contractions, net of inflation. Odds favor a nominal result somewhat weaker than likely consensus forecasts.

Industrial Production -- As discussed and graphed in the Opening Comments and detailed in the December 16th *Flash Update*, the Federal Reserve reported that seasonally-adjusted November industrial production fell by 0.6% (down 1.1% net of revisions) for the month, after a revised 1.5% (previously 1.3%) gain in October. The year-to-year decline in November production was 5.5%, following a revised 4.5% (was 4.0%) drop in October. Consistent with the still-deepening recession, fourth-quarter 2008 production is on track for roughly a 10% annualized quarterly contraction, following an 8.9% contraction in the third quarter.

With the December manufacturing purchasing managers survey showing a sharp monthly drop in production activity, to the lowest index reading ever (since January 1948), a further sharp decline in the Fed's production measure likely will follow.

Next Release (January 16): December production should show sharply deepening month-to-month and year-to-year declines.

New Orders for Durable Goods -- The regularly-volatile new orders for durable goods continued plunging on both a month-to-month and year-to-

year basis in November. November's seasonally-adjusted monthly decline of 1.0% (3.2% net of revisions) followed a revised drop of 8.4% (previously 6.2%). Year-to-year change continued to decline in a pattern confirming a deepening a severe recession. Before any accounting for inflation, November's new orders were down 17.6% from November 2006, against October's revised 12.9% (previously 10.6%) decline from October 2007. Following an annualized third-quarter contraction of 8.1%, new orders in the fourth quarter were falling at a still-preliminary pace of roughly 37%.

The widely followed new orders for nondefense capital goods fell by 0.8% for the month of November, after a revised 6.5% (previously 3.6%) decline in October. Year-to-year, orders fell by 20.8%, following a 13.2% (previously 11.3%) annual drop in October.

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 -- As discussed in the December 12th *Flash* Update, the seasonally-adjusted October trade deficit widened to $57.2 billion from a revised $56.6 billion (previously $56.5 billion) in September, reflecting a sharper decline reported in exports than in imports.

Unusual in the data was a renewed surge in the physical volume of October oil imports, which was suggestive of catch-up reporting. Prior data had helped to limit the scope of the reported third-quarter GDP contraction. Seasonally-unadjusted October oil entered the U.S. at a pace of 10.5 million barrels per day, up from 8.4 million in September, contrasted with last year's respective October and September import rates of 10.2 million and 10.1 million. The reported average price for imported oil dropped to $92.02 per barrel in October, from $107.58 in September, helping to offset in total dollars the gain in physical oil imports.

Next Release (January 13): Any further deterioration in the trade deficit for November likely will be softened further by sharply falling oil prices. It will be interesting to see if there is any further post-election catch-up in reporting. If there is, then the reported November deficit likely will be worse than consensus estimates.

Consumer Confidence -- Extremely volatile, but still showing an economy in deepening trouble, the December consumer confidence numbers were mixed, after flattening in November and collapsing in October. The Conference Board's December Consumer Confidence measure fell by 15.0% for the month, to an all-time low reading (lowest since the Lyndon Johnson Administration), after rebounding 15.2% in November from a 36.8% plunge in October. Year-to-year change for the three-month moving average deepened to a decline of 55.6%, from a drop of 48.7% in November and a 47.1% decline in October.

The Reuters/University of Michigan's Consumer Sentiment measure rose by 8.7% for the month of December, after declining by 4.0% in November and dropping by 18.1% in October. Year-to-year change in the Sentiment three-month moving average eased to a decline of 25.6% in December, following a 23.8% fall in November and a 22.9% drop in October.

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 continued to slow, intensifying recessionary pressures and highlighting difficulties the Federal Reserve has had in stabilizing the solvency issues in the U.S. banking system. With direct intervention as a lender in the commercial paper market, and with heavy jawboning of banks to lend to credit-worthy customers, the Fed has pushed to stimulate both commercial and consumer lending. Early indications in the money data of improving conditions in lending post-date the numbers available here.

For seasonally-adjusted consumer credit, which includes credit cards and auto loans, but not mortgages, annual growth was reported at 3.1% in October, down from 3.5% (previously 3.7%) in September, and down from 3.8% (previously 3.9%) in August.

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 contraction in commercial paper outstanding has narrowed minimally, with the Fed's proactive involvement in the market. Commercial paper outstanding showed a 13.1% year-to-year contraction in November, following a 16.2% year-to-year contraction in October and a 13.2% annual decline in September.

Annual growth in November commercial and industrial loans slowed to 13.3%, down from 15.1% in October and versus 13.2% in September. Slowing growth in commercial lending tends to dampen broad business activity.

Producer Price Index (PPI) -- As discussed in the December 12th *Flash Update*, the regularly volatile Producer Price Index (PPI) for finished goods absorbed another severe hit from the recent collapse in oil prices, contracting by a seasonally-adjusted 2.2% (2.9% unadjusted) in November, versus a 2.8% (2.6% unadjusted) decline in October, as reported by the Bureau of Labor Statistics. Going against a 2.6% monthly spike in the November PPI of last year, the current November's PPI year-to-year inflation fell to 0.4% from 5.2% in October.

If the monthly PPI should decline by 1% or more in December's reporting, a year-to-year deflation number would be likely for the series. Since 1980, the finished goods PPI has shown formal deflation (year-to-year decline) in 1986, 1994, 1997/1998 and 2001/2002, without the CPI ever following suit. Those declines and related index volatility often were tied to large swings in oil prices.

On a monthly basis, seasonally-adjusted November intermediate goods fell by 4.3% (down 3.9% October), crude goods fell by 12.5% (down 18.6% October). Year-to-year inflation slowed sharply, with November intermediate goods up by 2.6% (10.2% October) and November crude goods down by 19.4% (down by 1.4% October).

Next Release (January 16): Allowing for the ongoing, regularly random volatility of the monthly price variations, PPI inflation reporting over the next six-to-nine months generally should favor upside surprises in official results, despite another monthly hit in December, with annual PPI possibly turning negative in December as a result of the impact from lower 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 -- The December manufacturing purchasing managers survey took a further big hit, to 32.4, down from 36.2 in November, and down from 38.9 in October. Key December components indices for new orders and production hit their lowest levels ever, pre-January 1948. The November nonmanufacturing purchasing managers survey also took a big hit. Both series have fallen deep into recession territory (32.4 for December manufacturing, 37.3 for November nonmanufacturing).

The Institute for Supply Management (ISM) designates a reading of 41.1or below in its aggregate indices as signaling recession. The ISM reweighted its key index last January so that the manufacturing index 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 index. Fortunately, however, the more meaningful components of the index were not affected by the efforts to match the flawed government data.

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, which is the reading I use as a signal for contracting economic activity.

The December new orders index plummeted to 22.7 in December from 27.9 in October, and stood at its lowest reading ever. 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 December new orders index plunged by 45.6%, following a 37.8% decline in November and a 25.9% drop in October.

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 fell to 29.9 in December, the lowest reading since November 1982, down from 34.2 in November and from 34.6 in October.

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 November services composite index fell to 37.3, from 44.4 in October, and from 50.2 in September.

Both the services employment and prices paid components, however, have some meaning. Covering the real estate and banking industries, among others, the November employment component tumbled to 31.3, from 41.5 in October, and from 44.2 in September. The heavily hit

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prices-paid components for both indices are covered in the Inflation Indicators.

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

The seasonally-adjusted November help-wanted advertising index continued at its historic low level of 14, the same as in October, down from the prior historic low of 15 in September. These readings are at the lowest level seen since the index was first calculated during the Truman Administration, in January 1951.

The November reading was down by 33.3% year-to-year, versus a 36.4% decline in October, as the series continued to bottom-bounce. The annual change in the three-month moving average as of November was a 35.8% decline, versus October's 36.2% contraction. 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 November 2008, with a year-to-year 15.0% decline in new on-line ads. Such cannot be a good sign for national employment or for broad economic activity.

Housing Starts -- As discussed in the December 16th *Flash Update* and in the Opening Comments, and as graphed there net of the New York City paperwork distortions in June's reporting, housing starts continued to show a severe, deepening recession. The Census Bureau reported that seasonally-adjusted November housing starts fell by 18.9% (down 21.0% net of revisions) +/- 10.5% (95% confidence interval), a statistically-significant decline for the month. Such followed a revised 6.4% (previously 4.5%) decline in October. On a year-to-year basis, starts were down by 47.0%, after a revised 39.5% (previously 38.0%) drop in October.

November building permits showed a similar pattern, down 15.6% (13.0% net of revisions) for the month, following October's revised 9.3% (previously 12.0%) decline. Permits fell by 48.1% year-to-year in November, after an annual drop of 38.2% (previously 40.1%) in October.

In home sales data, the seasonally-adjusted November new home sales fell by 2.9% (down by 6.0% net of revisions) +/- 14% (95% confidence interval), which was not statistically distinguishable from a monthly gain, following a 5.2% (previously 5.3%) monthly decline in October. On a year-to-year basis, November new home sales dropped by 35.3%, following a 42.0% (previously 40.1%) decline in October. Even reflecting the intensifying upside pressures from the impact of foreclosure sales, existing home sales in November still fell by 8.6% (9.8% net of revisions) for the month, and declined 10.6% year-to-year. October monthly sales were down a revised 4.5% (previously 3.1%).

Inflation Indicators

Money Supply -- As discussed and graphed in the Opening Comments and the December 31st *Flash Update*, annual growth in the seasonally-adjusted December 2008 monthly averages for M1, M2 and SGS-Ongoing M3 money measures appears to

have spiked. Based on the latest three-plus weeks of reporting of M2 and non-M2 components of M3, annual M3 growth appears to have bottomed in November at 8.9%, with a rebound to an estimated 10.4% in December.

Slowly beginning to absorb the extreme liquefaction of the system by the Fed, December M1 annual growth is estimated at 16.3%, following 11.5% growth in November and 7.6% growth in October. December M2 annual growth is estimate at 9.5%, after November's growth of 7.6% and October's growth of 7.4%. December annual growth in the SGS-Ongoing M3 is estimated at 10.4%, after an 8.9% gain in November, and a 10.7% gain in October. Respective monthly gains reported or estimated in the seasonally-adjusted monthly average for October, November and December are 1.3%, 3.4% and 4.3% for M1, 1.4%, 0.7% and 4.3% for M2, and contractions of 0.4% and 0.3%, and a gain of 2.3% for M3. These data will be updated in the weeks ahead as more information becomes available.

Annual growth in the seasonally-adjusted SGS-Ongoing M3 continued has slowed from its record-high 17.4% level in March 2008. The slowing growth reflected serious difficulties the Fed had in getting banks to resume normal commercial activity, although some positive impact now has begun to surface. With Fed actions working their way into the system, not only should significantly higher broad money growth result, but also money velocity should increase as bank lending and financial markets return to some semblance of normalcy, and as consumers begin to pull cash out from underneath their mattresses (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).

Outside of the strong growth seen early in 2008, 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 December's growth likely was shy of 1971's high, the current environment still promises much stronger broad money growth in the months ahead and heavy upside inflation pressure well into 2009.

General background note: Historical annual growth data and monthly levels 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 published series can be linked to earlier historical data available from the St. Louis Fed. 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 -- Prices paid in both the December manufacturing and November nonmanufacturing surveys have plummeted, showing extreme declines in inflationary pressures, thanks primarily to the severe plunge in oil prices.

On the manufacturing side, the December prices paid index dropped to a 60-year low (since June 1949) of 18.0, from 25.5 in November, and from 37.0 in October. On a three-month moving average basis, December's year-to-year change was a collapse of 59.4%, versus a November annual decline of 38.8% and an October annual decline of 9.5%. 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 November prices diffusion index also dropped, falling to 36.6, from 53.4 in October, and from 70.0 in September. On a three-month moving-average basis, November's annual decline was 21.9%, versus October's annual gain of 2.7%, and September's annual gain of 18.9%.

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 below 50.0 indicates falling prices.

Oil Prices -- The ongoing collapse in oil prices has been the primary factor behind the drop in reported annual CPI inflation. There are some suggestions, however, that the plunge in oil prices may have about run its course, what with the U.S. election out of the way, with global political tensions returning to their normal inflated states, and with the U.S. dollar coming under some renewed selling pressures.

With the West Texas Intermediate (WTI) spot price closing at $44.60 per barrel on December 31st, oil prices have plunged by 69.4% since the record-high closing price of $145.66 on July 11, 2008, and have collapsed well below the $90 per barrel that level that promised ongoing severe near-term inflation problems in the U.S. economy. December's monthly average spot price for WTI (St. Louis Fed) was $41.36 per barrel, down 28.0% from November's $57.44, which was down by 25.1% from October's $76.65 per barrel. The December average was down 69.1% from June's $133.93 historic-high average. For December 2008, the year-to-year change in price level was a decline of 54.9%, versus a decline of 39.3% in November.

In terms of annual average for WTI, however, 2008 still set an historic high of $99.60 per barrel, up by 37.6% from $72.36 in 2007, which, in turn, was up by 9.5% from $66.10 in 2006.

As discussed in the Opening Comments, the continued drop in oil and gasoline prices has hammered reported CPI-U inflation sharply in October and November, and it will hit December, as well, triggering perhaps a brief period of official, albeit minor, year-to-year CPI-U deflation. There still remains in play, however, the long-term impact from recent high oil prices that still is working its way through the broad economy, and still will add upside pressures to general inflation (exclusive of the near-term energy measures) into the first half of 2009.

There also should be some lag in the full impact of drop in oil prices flowing through to the CPI, irrespective of overly optimistic reporting out of the Bureau of Labor Statistics. A number of firms (such as airlines) hedged their energy costs by buying oil futures, locking in their costs and protecting themselves from the negative impact of potentially still higher oil prices. Such activity is standard and good business practice. Any higher costs now locked in, still were done presumably at levels that were acceptable to the involved businesses, although they now are being worked off. On the other hand, any oil prices locked in now could be of great benefit going forward, slowing the growth in future energy-related inflation costs, should oil prices go higher, as I believe they will.

Beyond immediate fuel costs, oil-related costs impact industries ranging from the transportation of goods and services, to material costs in the plastics, pharmaceutical, fertilizer, chemical industries, etc. These broad inflationary pressures will remain intact for a while, despite any near-term oil price gyrations.

Oil prices remain highly volatile and sensitive to minor surprises. While slowing U.S. and global economies reduce oil demand, OPEC activities have been and likely will continue to be aimed at offsetting such, with production cuts. Adding some upside pressure to prices are intensified global military and political tensions, and other supply and demand risks/issues. Of greatest long-

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term impact, however, is the U.S. dollar, where oil is denominated in same. At such time as heavy dollar selling resumes -- and it may be starting -- look for oil prices to spike anew, moving back above the $100 per barrel level and rekindling oil-price related inflation concerns.

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Reporting/Market Focus

GAAP-Based 2008 Federal Deficit Hits $5.1 Trillion

Government Bankruptcy/Hyperinflation Just a Matter of Time

As discussed in the December 15th *Alert*, the U.S. Treasury published its *2008 Financial Report of the United States Government* on December 15th: http://fms.treas.gov/fr/08frusg/08frusg.pdf. A summary of the generally accepted account principles (GAAP)-based detail is shown in the following table:

U.S. Government - Alternate Fiscal Deficit and Debt
Reported by U.S. Treasury

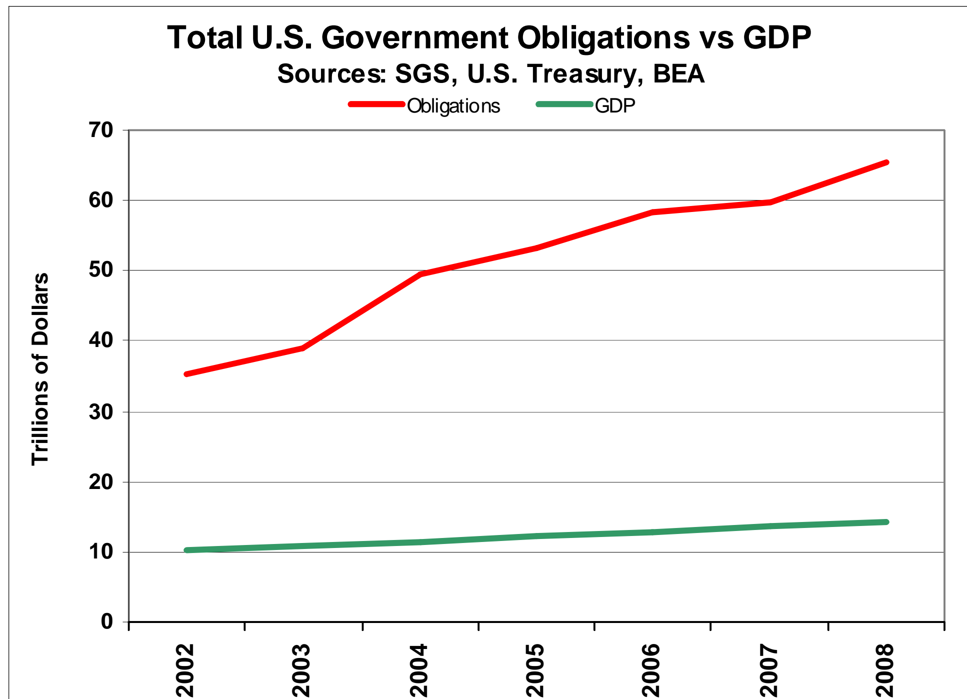
Dollars are in either billions or trillions, as indicated.
Sources: U.S. Treasury, Shadow Government Statistics.

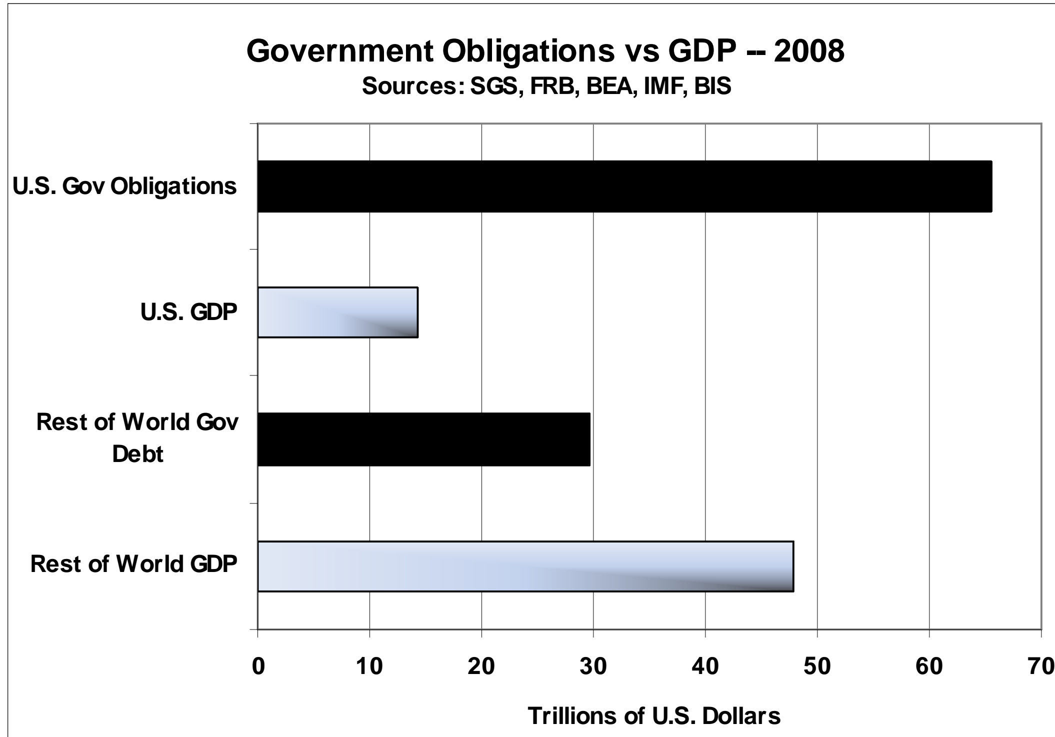
Fiscal Year (1)	Formal Cash-Based Deficit ($Bil)	GAAP Ex-SS Etc. Deficit ($Bil)	GAAP With SS Etc. Deficit ($Tril)	GAAP Federal Negative Net Worth ($Tril)	Gross Federal Debt ($Tril)	Total(2) Federal Obligations (GAAP) ($Tril)
2008	$454.8	$1,009.1	$5.1	$59.3	$10.0	$65.5
2007	162.8	275.5	1.2(3)	54.3	9.0	59.8
2006	248.2	449.5	4.6	53.1	8.5	58.2
2005	318.5	760.2	3.5	48.5	7.9	53.3
2004	412.3	615.6	11.0(4)	45.0	7.4	49.5
2003	374.8	667.6	3.0	34.0	6.8	39.1
2002	157.8	364.5	1.5	31.0	6.2	35.4

(1) Fiscal year ended September 30th. (2) Includes gross federal debt, not just "public" debt. While the non-public debt is debt the government owes to itself for Social Security, etc., the obligations there are counted as "funded" and as such are part of total government obligations. (3) On a consistent reporting basis, net of one-time changes in actuarial assumptions and accounting, SGS still estimates that the GAAP-based deficit for 2007 topped $4 trillion, with negative net worth of $57.1 trillion and total obligations of $59.8. So as to maintain consistency with the official GAAP statements, the "official" numbers are shown in the table for 2007. (4) SGS estimates $3.4 trillion, excluding one-time unfunded setup costs of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (enacted December 2003). Again, in order to maintain consistency with the official GAAP statements, the "official" numbers are shown in the table for 2004. Link to the 2008 statements: http://www.fms.treas.gov/fr/08frusg/08frusg.pdf

Against what had been the recently publicized, cash-based "official" fiscal 2008 (year-ended September 30th) federal deficit of $454.8 billion, and parallel $161.8 billion deficit in 2007, the U.S. Treasury reported that the 2008 deficit [change in net position] was $1,009.1 billion, versus $275.5 billion in 2007, using GAAP. Since 2002, the Treasury has been reporting the government's finances using annual statements prepared using accounting standards similar to those used in corporate America.

Those numbers, however, did not account for the annual change in the net present value of unfunded Social Security and Medicare liabilities, except in discussions and footnotes. Counting those changes, as a corporation would for its pension and healthcare liabilities for retirees, the 2008 annual deficit was $5.1 trillion, versus $1.2 trillion in 2007. Such showed total U.S. obligations -- gross federal debt outstanding plus the net present value of unfunded liabilities -- at $66 trillion, roughly 4.6 times the level of reported U.S. GDP, and greater than total estimated global GDP. These numbers are unsustainable, as suggested in the accompanying graphs, and already are deteriorating severely for fiscal 2009. They also doom the U.S. dollar to hyperinflation, as discussed in the *Hyperinflation Special Report* of April 8, 2008.





An actual U.S. deficit of $5.1 trillion is uncontainable, and it is about to get a great deal worse. The shortfall cannot be covered by taxes, and the needed spending cuts tied to Social Security and Medicare cannot be worked politically. The rapidly deteriorating economic conditions promise reduced tax revenues, while the incoming Obama Administration has promised significantly increased spending.

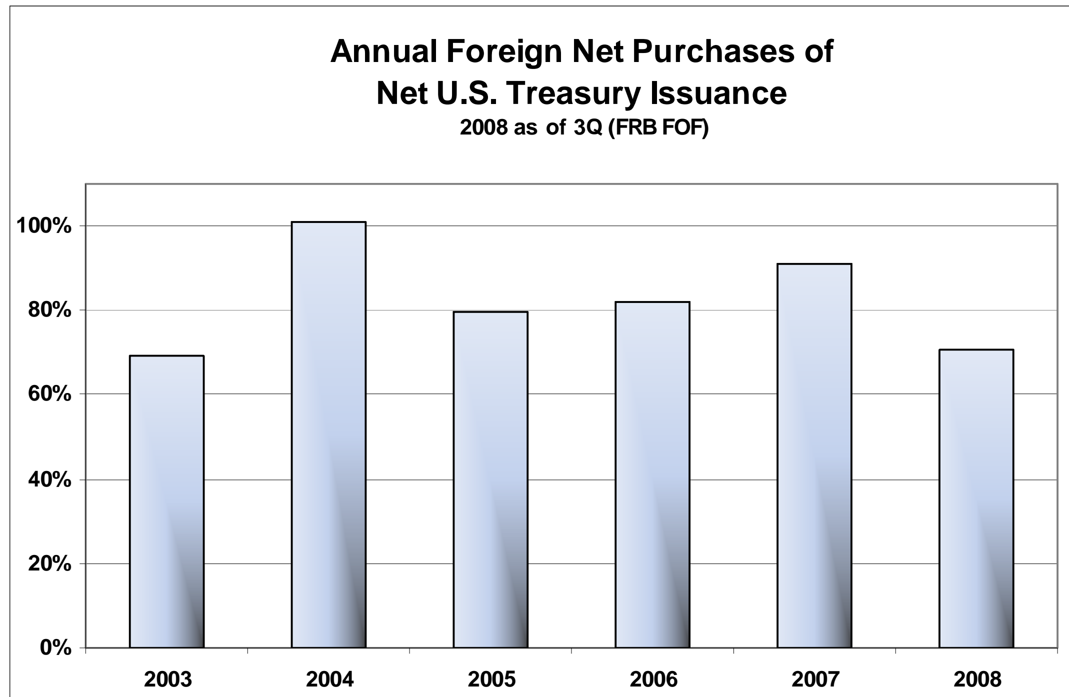
Impact of Systemic Solvency Crisis to Be Seen in 2009 Numbers. As the U.S. Treasury responded in tandem with the Federal Reserve in 2008 to address a collapsing financial system, placing Freddie Mac and Fannie Mae into conservatorship added about $13 billion to the annual deficit and government liabilities for fiscal 2008. Most of the impact from that and other actions, however, will not show up until 2009 accounting. In like manner, the Troubled Asset Relief Program (TARP) was not enacted until fiscal 2009 and will be so accounted for.

As reported so far in fiscal 2009 (see the Federal Deficit comments in the Reporting section), the "official" cash-based (not GAAP-based) accounting shows for October and November 2008 -- the first two months of the 2009 fiscal year -- that the official deficit more than doubled to $401.6 billion, from $154.1 billion in the same period of fiscal 2008.

Faced with collapsing economic activity, President-elect Obama has promised a massive economic stimulus package that likely will total close to $1 trillion, spiking the "official" cash-based deficit to possibly $2 trillion in fiscal 2009, more than four times the 2008 record level. All that will have to be funded by the U.S. Treasury, on top of its regular refunding needs. Therein lies a problem for the markets and the incoming Administration.

U.S. Treasury funding needs exploded by about $500 billion in October 2008. Yet, even as Treasury issuance began to spike in calendar third-

quarter 2008, foreign purchases of those instruments began to falter, as reflected in the Federal Reserve's flow-of-funds data, which tend to be unreliable. Nonetheless, the U.S. Treasury has relied on foreign net purchases of an average 80% of its net debt issuance since 2002. As foreign investors increasingly shy away from a losing proposition with the U.S. dollar, faltering demand for U.S. Treasuries will become a problem for the Federal Reserve, the U.S. Treasury buyer of last resort. At such time as the Fed monetization of U.S. debt accelerates meaningfully, the risks of hyperinflation will move in over the horizon.



Risks of U.S. Default. As discussed in the prior newsletter, stories keep circulating in the global markets of a possible default on U.S. debt within the next year or so, as result of the explosive growth in federal debt. Such remains unlikely, unless foreign lenders start making not-so-unreasonable demands that the United States issue its debt in yen, pounds, euros, etc. As shown by the latest GAAP-statements, the United States already had no prospects of ever honoring the obligations that were in place before the current crisis, which will push this year's cash-based deficit possibly to $2 trillion (perhaps $8 trillion GAAP). Under such circumstances, most governments would opt to use the printing press to inflate their way out of debt, rather than to go through a formal debt default.

That is why the agencies that issue sovereign debt ratings usually will give a "AAA" rating, when debt is issued in the sovereign's currency, backed by the power of being able to create whatever currency is needed in order to meet the obligations.

If, however, the U.S. had to start covering new obligations in something other than the U.S. dollar, then the risk of formal default would become meaningful, and sovereign ratings on non-dollar U.S. Treasury debt easily could fall below

investment grade. Given that the U.S. government has no way out of its obligation bind within the traditional system, offering non-U.S. dollar denominated debt would not be a desirable option. Such would raise the risk of actual debt default and a possible ratings downgrade that would not otherwise be seen, while possibly accelerating the onset of hyperinflation in the process.

PLEASE NOTE: The next SGS Newsletter currently is targeted for the end of January. Intervening Flash Updates and Alerts will be posted in response to key economic and/or financial-market developments.

Earlier editions of the SGS writings and Special Reports referenced in the text can be found on the Archives tab at www.shadowstats.com.

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