

John Williams'
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Analysis Behind and Beyond Government Economic Reporting

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Markets, July Retail Sales, June Trade Balance

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Financial Circumstances Remain Unstable and Threatening

U.S. Dollar Is in Serious Trouble

Retail Sales Gain Was Statistically Meaningless and Largely Reflected Inflation

Trade Data Suggest Downside Pressure on Upcoming GDP Revision

PLEASE NOTE: The next regular Commentary is scheduled for Thursday, August 18th. It will cover July 2011 CPI, PPI, industrial production and housing starts. A Special Comment would be published, as appropriate, in response to any unusual market or economic developments.

—Best to all, John Williams

Opening Comments and Executive Summary. The U.S. markets have not reacted well to the significant loss of global confidence in the U.S. dollar and in the U.S. government, and to the growing concerns of intensifying economic and systemic-solvency crises. The unfolding crises of the last couple weeks have been exacerbated by comments out of the Fed and the Administration, who have no realistic, short-term positive options to offer to the system and the markets.

The extreme volatility in a number of markets has reflected massive crosscurrents, shifting positions and covert and overt interventions by governments and central banks. Ahead will be still further extreme volatility in the U.S. dollar against the stronger currencies and against gold. At such time as intervention eases and somewhat normal market pressures come into play, the dollar should lose out. The U.S. currency increasingly will come under broad selling pressure, regularly setting historic lows against the Swiss franc, the Canadian dollar and the Australian dollar, while the gold price will move higher, setting successive historic highs. Oil prices—in dollar terms—also likely will rally sharply against the weakening dollar. Again, this is the longer-term picture, beyond the current, panicked markets.

There have been heavy intervention, jawboning and overt actions to prop the U.S. dollar. After the dollar pushed to successive historic lows against the Swiss franc—despite near-term efforts by the Swiss National Bank (SNB) to debase the franc—the SNB went so far as to threaten to peg the franc to the euro. Such actions against market forces tend to be short-lived at best. If the franc were pegged to the euro, the intervention needed to maintain that relationship would become prohibitively expensive, very quickly, for the SNB, as the Swiss central bank effectively would be intervening to prop the euro.

Beyond the currency markets, it has been decades since the U.S. financial markets could have been considered free and open. Accordingly, when major overt and covert interventions come into play, it is nonsensical for the financial media to hype fundamental interpretations to those rigged movements. The President's Working Group on the Financial Markets (PWGFM) is active, and official interventions and market machinations have been at play to stabilize the markets, although the specifics usually are not announced.

Suspect actions have been seen at least twice in U.S. stock market trading during the last week. First was the late-afternoon rally on Friday, August 5th, in advance of the S&P announcement of the downgrade to the U.S. sovereign debt rating. The U.S. government knew the downgrade was coming. If, as indicated by Allen Greenspan that the PWFGM intervened in the markets as the news was breaking on the planned invasion of Iraq, it most likely also would have acted in advance for something as market-rattling as the downgrade. Second was the stock rally following the FOMC announcement on August 9th. Interventions purportedly are worked through purchases of stock futures, handled by large, former investment banks, on behalf of the PWGFM, as directed by the New York Fed.

As to the Treasury market, the Federal Reserve has held that under tight control for some time, having increased its net holdings of U.S. Treasuries, since the onset of QE2, by more than the Treasury's net issuance of securities for public holding during that same period. Given the Fed's interrelationship with the banking system, it can move Treasury yields at will. Treasuries increasingly will be the last place private investors would want to hold their money.

Fed Has Little Choice But to Put Forth Some Form of QE3. Beyond the pabulum fed to the public about the Fed's mandate to contain inflation and to maintain ongoing economic growth, the Fed's primary mission remains to keep the banking system afloat. Politically, the economy follows that in priority, and then inflation. The statement following Tuesday's Federal Open Market Committee (FOMC) meeting indicated nothing of policy substance. Extending the low-interest-rate environment into 2013 (no support for the U.S. dollar here) is a policy that could be changed at a moment's notice. There was no hint of a QE3.

The tone of the FOMC's comments, however, shifted significantly towards the view of an unfolding double-dip recession. The ongoing system-liquidity crisis will require the Fed to provide more liquidity to the banking system. To the extent that action comes forward as an overt QE3, it will be touted as justified by the weakening economy. If the action is covert, the Fed can just keep doing whatever it wants to do.

July 2011 Retail Sales. The 0.5% monthly gain estimated for July retail sales was not meaningful, where the 95% confidence interval around the reported change also allowed for an outright monthly contraction. Separately, most—if not all—of the monthly gain was accounted for by higher prices, not by a rising volume in physical consumption of goods and services. Net of increases in gasoline-station and grocery-store revenues (surrogates for gasoline and food inflation), monthly retail sales rose by 0.2%.

June 2011 Trade Deficit. The June deficit widened “unexpectedly” to \$53.1 billion from \$50.8 billion in May, hitting its worst level since October 2008. The number also widened net of inflation, with a now-complete second-quarter trade estimate suggesting a downside revision (August 26th) to the “advance” estimate of second-quarter 2011 GDP, which was based on only two months of trade reporting for the second quarter. Other GDP components, however, also could be revised and offer some offset to the new trade numbers.

Hyperinflation Watch. The financial markets have been roiled by crises of confidence in the U.S. dollar and in the long-term outlook for U.S. financial, economic, systemic and political stability. For those living in a U.S. dollar-denominated world, regardless of any further near-term extreme volatility in the U.S. dollar, versus the stronger major currencies and gold, the stronger currencies and precious metals remain the fundamental hedges against what lies ahead.

Massive, fundamental dollar dumping and dumping of dollar-denominated assets could start at anytime, with little or no further warning. With a U.S. government unwilling to balance or even address its uncontrollable fiscal condition; with the federal government and Federal Reserve ready to prevent a systemic collapse, so long as it is possible to print and spend whatever money is needed; and with the U.S. dollar at risk of losing its global reserve currency status; much higher inflation lies ahead, in a circumstance that rapidly could evolve into hyperinflation.

The broad inflation and economic outlooks discussed in the [Hyperinflation Special Report \(2011\)](#) continue to unfold and are unchanged. An updated economic and inflation outlook will follow in the August 18th *Commentary*.

REPORTING DETAIL

RETAIL SALES (JULY 2011)

July Retail Sales Gain Largely Was Due to Inflation Gains, Not to Gains in Physical Demand. The 95% confidence interval around the month-to-month reported July retail sales gain of 0.5% also allows for an outright contraction. Accordingly, the reported gain in sales was not statistically meaningful. Nonetheless, the bulk of, if not the entire reported monthly gain in retail sales was due to rising prices, not to increased physical volume of the goods and services consumed.

Additionally, as previously discussed (see the [Hyperinflation Special Report \(2011\)](#) for example), the retail sales numbers undergo concurrent seasonal-factor adjustment, where current and historical seasonal factors are revised every month. The stability of the seasonal-adjustment process, however, has been disrupted by the unprecedented depth and length of the current economic downturn in the post-World War II era (the period of modern economic reporting). These issues have distorted monthly reporting for a number of key series, leaving the markets effectively flying blind on actual underlying economic activity. That said, the latest seasonal recalculations appear to have contributed to the reported, but statistically meaningless, monthly July retail sales gain. Further, ongoing positive biases in the retail sales surveys should be corrected in downside revisions to the historical data in next year's benchmark revisions.

Nominal (Not-Adjusted-for-Inflation) Retail Sales. Today's (August 12th) report on July 2011 retail sales—issued by the Census Bureau—indicated a statistically-insignificant, seasonally-adjusted monthly increase of 0.47% (up by 0.68% before prior-period revisions) +/- 0.6% (95% confidence interval), versus a revised June increase of 0.28% (previously up by 0.14%).

On a year-to-year basis, July 2011 retail sales were reported up by 8.53%, versus a revised year-to-year June 2011 gain of 8.33% (previously 8.06%).

Real (Inflation-Adjusted) Retail Sales. Details on real retail sales for July will be published in the August 18th *Commentary*, along with details on the July 2011 CPI-U release. Given seasonal factors that will boost reported gasoline prices, higher food prices and the spreading impact of the higher oil prices through the broad economy, real retail sales for July likely were flat, month-to-month, and may have contracted.

Core Retail Sales. Assuming that the bulk of non-seasonal variability in food and gasoline sales is in pricing, instead of demand, “core” retail sales—consistent with the Federal Reserve’s preference for ignoring food and energy prices when “core” inflation is lower than full inflation—are estimated using two approaches:

Version I: July 2011 versus June 2011 seasonally-adjusted retail sales—net of total grocery store and gasoline station revenues—was up by 0.3% versus an official aggregate gain of 0.5%.

Version II: July 2011 versus June 2011 seasonally-adjusted retail sales—net of the monthly change in revenues for grocery stores and gas stations—was up by 0.2% versus an official aggregate gain of 0.5%.

TRADE BALANCE (JUNE 2011)

Full Quarterly Trade Data Suggest Downside Revision to Second-Quarter GDP. As suggested by the two months of second-quarter trade data available for the “advance” second-quarter GDP estimate, the relative improvement in the second-quarter trade deficit helped to prop up the 1.3% inflation-adjusted, annualized quarterly growth rate. With the June 2011 trade balance report, however, the second-quarter trade deficit largely is set, and the more-complete, quarterly trade deficit deteriorated enough, in revision, potentially to offset the better part of the 0.6 percentage point positive contribution to the initial GDP estimate. Of course there will be other revisions to GDP components, and some may offset the trade data, at least partially. The GDP revision is due on August 26th.

Nominal (Not-Adjusted-for-Inflation) Trade Deficit. The Bureau of Economic Analysis (BEA) and the Census Bureau reported Thursday (August 11th) that the nominal, seasonally-adjusted monthly trade deficit in goods and services for June 2011 widened to \$53.1 billion from a revised \$50.8 (previously \$50.2) billion in May. The June 2011 deficit also widened from \$47.9 billion a year ago and was the largest monthly deficit reported since October 2008.

Against May, the June trade balance showed a greater decline in exports than was seen in imports. Oil prices dampened import values in the month. Specifically, for the month of June 2011, the not-seasonally-adjusted average price of imported oil was \$106.00 per barrel, down from \$108.70 in May 2011, but up from \$72.39 in June 2010. In terms of not-seasonally-adjusted physical oil imports, June 2011 volume averaged 9.889 million barrels per day, up from 8.879 million in May 2011, but down from 10.443 million in June 2010.

Real (Inflation-Adjusted) Trade Deficit. Adjusted for seasonal factors and net of rising oil prices and other inflation (2005 chain-weighted dollars as used in reporting real GDP), the reported June 2011 merchandise trade deficit came in at \$50.9 billion, up from a revised \$47.9 (previously \$47.8) billion in May.

Based on the initial full reporting for the quarter, the real second-quarter 2011 merchandise deficit annualized out to \$569.7 billion (up from \$550.2 billion based on two months), versus a revised \$603.1 (previously \$604.9) billion in the first-quarter. The \$19.5 billion net deterioration in the data is enough to suggest a greater trade shortfall in the GDP’s net export account, along with some resulting downside revision to second-quarter GDP growth.

Week Ahead. Though still not widely acknowledged, there is both an intensifying double-dip recession and a rapidly escalating inflation problem. Until such time as financial-market expectations fully catch up with underlying reality, reporting generally will continue to show higher-than-expected inflation and weaker-than-expected economic results in the month and months ahead. Generally, previously unreported economic weakness should show up in prior-period revisions.

Residential Construction (July 2011). The release of July 2011 housing starts is scheduled for Tuesday, August 16th. The historic weakness in housing starts should continue, with an intensifying downtrend. Any upside movement likely will not be statistically meaningful.

Industrial Production (July 2011). The release of July 2011 industrial production also is scheduled for Tuesday, August 16th. July production could be flat to minus, as the broad economy begins its formal double-dip.

Producer Price Index—PPI (July 2011). The release of the July 2011 PPI is scheduled for Wednesday, August 17th. Finished goods inflation should top a likely soft consensus outlook, due to a swing into supportive seasonal factors for gasoline prices, and to spreading, broader inflationary pressures.

Consumer Price Index—CPI (July 2011). The release of the July 2011 CPI is scheduled for Thursday, August 18th, and it is at fair risk of topping what likely will be a soft consensus outlook. At work here will be a strong reversal in gasoline seasonal-factors that will boost gasoline prices, as further inflationary pressures from the Fed-induced jump in oil prices continues to spread in the broad, non-“core” economy.

Year-to-year total CPI-U inflation would increase or decrease in the July 2011 reporting, dependent on the seasonally-adjusted monthly change, versus the 0.35% gain in the adjusted monthly level reported for July 2010. I use the adjusted change here, since that is how consensus expectations are expressed. To approximate the annual inflation rate for July 2011, the difference in July’s headline monthly change (or forecast of same) versus the year-ago monthly change should be added to or subtracted directly from June 2011’s reported annual inflation rate of 3.56%. Annual CPI-U inflation should move to top 4% in the next couple of months.
