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July Trade Deficit, Turmoil in Financial Markets

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July Trade Deficit Suggests Possible Positive Contribution to Third-Quarter GDP

Swiss Intervention Unlikely to Have Lasting Impact

PLEASE NOTE: The next regular Commentary *is scheduled for Wednesday, September 14th. It will cover the release of the 2010 poverty report, and August 2011 retail sales and PPI. A subsequent* Commentary *on Thursday, September 15th, will cover the August CPI and industrial production. A* Special Commentary *would be published, as appropriate, in response to any unusual market or economic developments.*

—Best wishes to all, John Williams

Opening Comments and Executive Summary. In a relatively quiet week for economic releases, today's (September 8th) estimate of July's trade deficit had positive implications for an otherwise increasingly bleak outlook for third-quarter GDP. The sharp monthly narrowing in the July number reflected a gain in exports and a contraction in imports; the latter category was helped by lower oil prices and physical import volume. Revisions showed minimally smaller monthly deficits for January through June 2011 than previously had been reported.

The trade series, however, has been showing unusual volatility recently, and a repetition of the July number in August is not a good bet. A significant widening in the August deficit would eliminate the possible positive impact on GDP offered by today's number.

Areas of ongoing greatest concern, at the moment, are financial-market and financial system instabilities. Economic and inflation conditions will be updated with next week's economic releases and associated *Commentaries*.

Hyperinflation Watch—Market Turmoil Reflects Systemic Instabilities and Dangers. The U.S. and global financial markets remain extraordinarily volatile and unstable, with systemic instabilities offering the potential, again, of systemic failure. Following the collapse of Lehman in 2008, the U.S. Treasury and the Federal Reserve committed to preventing a systemic collapse at any cost. They created and spent, loaned or guaranteed whatever money was needed to forestall systemic failure, kicking the proverbial can down the road. Most of the actions taken then and since, however, were stopgap measures; little was done to address the systemic and economic crises fundamentally. At present, the system has moved enough further along the road that the can likely will be kicked again. Now, though, the road ahead drops off a cliff, well within current kicking distance.

To the extent that the systemic-solvency crisis in the euro area threatens a global and/or U.S. systemic collapse, or where the ongoing U.S. systemic-solvency crisis comes to a head, the Federal Reserve likely will stand ready as the lender or liquidity-provider of last resort—overtly or covertly—to prevent such an event, as it did in 2008/2009 and beyond. For the Fed, systemic failure is not an option.

Facing what looks to be a strongly anti-incumbent 2012 election, those controlling the federal government likely will push hard for some form of new stimulus to counter an unfolding and unavoidable double-dip recession, irrespective of deficit-reduction talk. President Obama is due to offer a new jobs program in a speech tonight.

As with the earlier emergency measures, any further stimulus or liquidity actions now by the federal government and/or the Federal Reserve likely will have limited positive impact on the crises, but they will have an ultimate cost to the United States in inflation. Accordingly, legitimate investor fears have been reflected in safe-haven flight of capital into gold and the Swiss franc, particularly since the debt-ceiling/deficit-reduction deal at the beginning of August.

With the Swiss franc soaring against other currencies—particularly against the U.S. dollar and the euro—the Swiss National Bank took a number of actions, including jawboning, to quell the pro-franc speculation. On Tuesday (September 6th), in an act of desperation, the SNB announced something akin to a fixed exchange rate for the franc versus the euro, where the SNB actively would support a floor value of the euro versus the franc.

It is highly unlikely that the SNB really wants to destroy the franc or to disrupt Switzerland's long history of fiscal prudence. If they wanted to do that, they would have joined with the euro a long time ago, and now would be suffering the same trials and tribulations as the Bundesbank in the euro crisis. Instead, as has happened at other times when the franc has been "too strong," short-term action has been taken to psych-out the markets, to discourage those wanting to hold francs. Intervention against market demand, however, as is required here, quickly becomes extremely expensive and disruptive to the intervener's financial system. Accordingly, the quasi-franc-euro-fix should prove to be short-lived, and the SNB knows that. Intervention and other measures are discussed on page 62 of the *Hyperinflation Special Report (2011)*.

As discussed in the recent *Commentaries* and repeated here, the broad inflation and economic outlooks detailed in the *Hyperinflation Special Report (2011)* continue to unfold and are unchanged. The financial markets still are unstable and extremely volatile, roiled by deepening 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 further near-term extreme volatility in the U.S. dollar—in either direction—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 to address its uncontainable fiscal condition; with the federal government and Federal Reserve standing 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.

REPORTING DETAIL

TRADE BALANCE (JULY 2011)

July Trade Data Suggest A Potential Positive Contribution to Third-Quarter GDP Growth. The monthly narrowing of July's reported trade shortfall would be a plus for third-quarter GDP reporting, should it be repeated next month. The series, however, has been showing unusual volatility in recent months, tied to the Japanese earthquake, and to oil and gold price variations, and I still expect the general trend in the U.S. trade deficit to be one of net deterioration. Revisions showed minimally smaller monthly deficits for January through June 2011 than previously had been reported.

Nominal (Not-Adjusted-for-Inflation) Trade Deficit. The Bureau of Economic Analysis (BEA) and the Census Bureau reported this morning (September 8th) that the nominal, seasonally-adjusted monthly trade deficit in goods and services for July 2011 narrowed to $44.8 billion from a revised $51.6 (previously $53.1) billion in June. The narrower July deficit and the revised June number were in the context of general revisions that reduced the magnitudes of trade deficits reported previously in first- and second-quarter 2011. The July 2011 deficit widened from an unrevised $41.8 billion in July 2010.

Against June, the July trade balance showed a gain in exports and a decline in imports. Lower oil prices and physical import volume helped to dampen import activity for the month. Specifically, for the month of July 2011, the not-seasonally-adjusted average price of imported oil was $104.27 per barrel, down from $106.00 in June 2011, but up from $72.09 in July 2010. In terms of not-seasonally-adjusted physical oil imports, July 2011 volume averaged 9.067 million barrels per day, down from 9.889 million in June 2011, and down from 9.937 million in July 2010.

Real (Inflation-Adjusted) Trade Deficit. Adjusted for seasonal factors and net of oil price swings and other inflation (2005 chain-weighted dollars as used in reporting real GDP), the reported July 2011 merchandise trade deficit came in at $45.3 billion, down from a revised $50.3 (previously $50.9) billion in June, and down from a monthly average of $47.3 billion in second-quarter 2011.

Based on just one-month's reporting, the annualized deficit for the third-quarter would be $543.3 billion, down from the full reporting of a revised annualized real second-quarter 2011 merchandise deficit of $567.4 (previously $569.7) billion. The potential quarterly narrowing of the deficit would be a positive for the GDP's net export account and, accordingly, for third-quarter GDP reporting.

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.

Annual Poverty Report (2010). Due for release on Tuesday, September 13th, the 2010 annual poverty survey should show some deterioration in most measures of poverty and household income. Look for ongoing declines in inflation-adjusted median and mean household income, as well as movement to a new extreme in income variance (shifting of income to lower and higher levels from the middle).

Retail Sales (August 2011). Due for release on Wednesday, September 14th, the August 2011 retail sales report is at fair risk of coming in below likely strong consensus estimates. In any event, consistent with reporting of recent months, any reported monthly retail sales gain should result primarily from higher prices, with a flat-to-minus showing for the month, net of inflation effects.

Producer Price Index—PPI (August 2011). The release of the August 2011 PPI is scheduled for Wednesday, September 14th. Finished goods inflation should top a likely soft consensus outlook, due to supportive seasonal factors for gasoline prices, and to the effects of still-spreading broader inflationary pressures from higher oil prices.

Consumer Price Index—CPI (August 2011). The release of the August 2011 CPI is scheduled for Thursday, September 15th, and it again is at fair risk of topping what likely will be a relatively soft consensus outlook. At work here will be a continued boost to gasoline prices from seasonal adjustments, while further inflationary pressures from the Fed-induced jump in oil prices continues to spread in the general, non-"core" economy.

Specifically, in terms of gasoline, unadjusted retail prices fell on average by 0.2% in August 2011 (Department of Energy). Paralleling what should be similar seasonal impact in 2011 reporting, a 0.4% unadjusted monthly gain in August 2010 was boosted to a 3.9% increase after seasonal adjustments.

The reported, unadjusted, total year-to-year CPI-U inflation would increase or decrease in August 2011, dependent on the reported seasonally-adjusted monthly change, versus the 0.21% gain in the adjusted monthly level reported for August 2010. I use the adjusted change here, since that is how consensus expectations are expressed. To approximate the annual inflation rate for August 2011, the difference in August's headline monthly change (or forecast of same) versus the year-ago monthly change should be directly added to or subtracted from July 2011's reported annual inflation rate of 3.63%. For example a 0.4% gain in the monthly CPI-U inflation should push annual August inflation up to about 3.8%.

Industrial Production (August 2011). The release of August 2011 industrial production also is scheduled for release on Thursday, September 15th. One-time factors (relatively extreme utility usage and the resumption of Japanese car assemblies in the United States) that boosted the initial estimate of July production by 0.9% are not likely to be repeated in the latest numbers. Accordingly, August's monthly change could be flat to minus, as the broad economy begins its formal double-dip recession.

