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

COMMENTARY NUMBER 427
March Labor Data, M3 and February Construction Spending

April 6, 2012

Headline Jobs Gain and Unemployment Rate Decline Were Statistically Insignificant

March Unemployment: 8.2% (U.3), 14.5% (U.6), 22.2% (SGS)

Construction Spending Stuck in Bottom-Bouncing Stagnation

QE3 Always Has Been Dependent on Systemic Crises, Not the Economy or Inflation (Economy Has Provided Fed Cover)

M3 Money Supply Growth Slipped in March, Signaling Potential Systemic Liquidity Crisis Intensification

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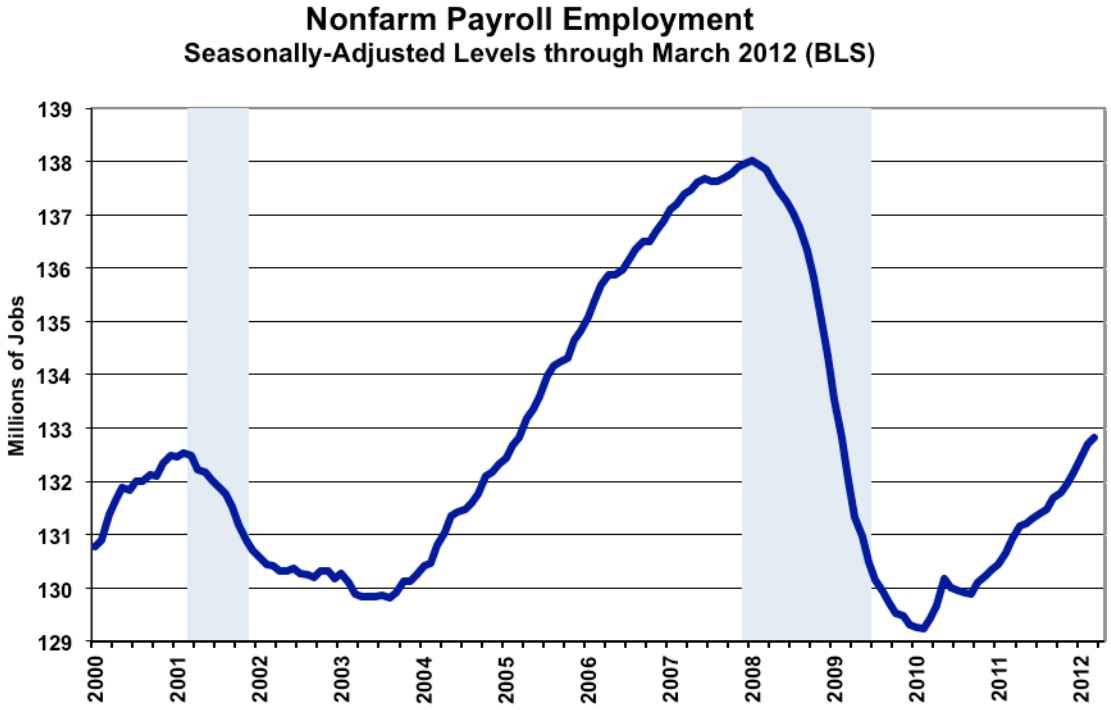
PLEASE NOTE: The next regular Commentary *is scheduled for Friday, April 13th, covering the March 2012 releases of the CPI and PPI, and the February trade balance.*

Best wishes to all — John Williams

Opening Comments and Executive Summary. The economic and systemic solvency crises persist, as discussed in the prior *Commentary No. 427*, and as further evidenced in the reporting of this last week. February construction continued in its protracted period of low-level stagnation; weaker March payroll growth reflected some likely catch-up from overstated jobs growth of the last several months; and M3

money supply growth appeared to be faltering anew in March, suggestive of intensifying systemic liquidity problems.

Employment and Unemployment. Despite recent likely overstatement of payroll employment, March payroll levels, as released today (April 6th), still remain well below the pre-2007 recession highs, as shown in the following graph.



The headline March labor numbers were not statistically meaningful. Reflecting the statistical confidence intervals around the reported changes, as established by Bureau of Labor Statistics (BLS), actual March payrolls may have declined, instead of having increased by the reported 120,000 versus February. In similar manner, the actual March unemployment rate could have increased, instead of having declined by the reported 0.1%. These data remain unstable and unreliable.

Although the reporting did reflect some minor catch-up in recently overstated employment growth, a significant weakening in the labor data likely remains pending. The household survey (unemployment rate) showed a 31,000 monthly decline in March employment, following an unbelievably strong gain reported in February of 428,000. The establishment survey (payroll employment) showed an increase of 120,000 jobs in March, just half of the revised 240,000 jobs gain reported for February. Nonetheless, the headline unemployment rate eased to 8.19% in March, from 8.27% in February, although, again, the change was statistically insignificant.

While the headline (U.3) March unemployment rate narrowed to 8.2%, from 8.3% in February, the government's broadest unemployment rate (U.6) narrowed to 14.5% from 14.9% in February. The drop in U.6 primarily reflected an ongoing reduction in, and seasonal-factor issues with, the count of people who were working part-time for economic reasons. Despite the mounting level of long-term discouraged workers, the SGS-Alternate unemployment rate narrowed to 22.2% in March, down from 22.4% in February, picking up some of the decline in the underlying U.6 series.

Popular financial media are attributing the March payroll weakness to catch-up from earlier reporting that had been boosted by an unseasonably warm winter. While there likely was some weather-related impact, the seasonal-factor distortions more broadly appear to have been, and remain tied to, a breakdown in the seasonal-adjustment process triggered by the extreme depth and duration of the current economic downturn. Month-to-month reporting, again, remains unstable and unreliable.

A Story in the Trend. In the near future, we shall begin publishing and analyzing payroll employment trends that are calculated as part of the BLS's seasonal-adjustment modeling, effectively expectations of what the monthly payroll numbers would show if existing trends continued. Before today's release, the trend projection was for a March payroll gain of 215,000 (close to consensus), with estimates for pending releases of 182,000 new jobs in April, and 201,000 in May. Following today's release of 120,000 jobs gain for March, the revised trend estimates have shifted to 152,000 for April and to 163,000 for May. The issues here will be detailed in the forthcoming new material and discussed in the last regular *Commentary* before the April employment report.

What is particularly interesting in the March trend is where expectations were not met. Of the 95,000 jobs that were shy of trend, 42,000 were in the retail sector, of which 33,000 were in general merchandise stores. While those changes could be attributable to weather distortions, at least partially, the numbers were after a 15,000 jobs downside revision to general merchandise stores in February. Professional and business services were shy of trend by 51,000, primarily in temp hiring, an area that has seen unusual seasonal variations (not obviously weather related) in the last several months. The balance of the trend shortfall generally was seen in government jobs (across the board), a category that should not suffer extreme variance because of a mild winter.

Construction Spending. On a monthly basis, March 2012 construction spending continued a pattern of bottom-bouncing—along a plateau of low-level of activity—that has been in place for three years. The 1.1% monthly decline (following a downward revision to February activity) was not statistically meaningful, and year-to-year growth effectively was flat, net of inflation.

Hyperinflation Watch. In the context of the updated economic background published in *Commentary No. 426*, and with full consideration to intervening economic, inflation and financial-market developments since the January 25, 2012 publication of the hyperinflation report, the broad economic, inflation and hyperinflation outlooks discussed in *Hyperinflation 2012* have not changed.

Money Supply M3 (March 2012). Based on more than three weeks of data, the preliminary estimate of annual growth for the March 2012 SGS Ongoing-M3 Estimate—to be published tomorrow (April 7th) in the Alternate Data section—is on track to slow to 3.4% from an unrevised 3.9% in February. With annual growth in January also at 3.9%, the upturn in annual growth that began in March 2011 appears to be

stalling or faltering. Faltering broad money supply growth—in an environment of massive Federal Reserve accommodation—remains suggestive of an intensifying systemic-solvency crisis.

The seasonally-adjusted, month-to-month change estimated for March 2012 M3 likely will be near flat for a second month, perhaps up by 0.1%. The estimated month-to-month M3 changes, however, remain less reliable than the estimates of annual growth.

Estimates of slightly slowing annual gain and relatively flat month-to-month change appear to have been the circumstance, again, in March for the narrower M1 and M2 measures (M2 includes M1, M3 includes M2). M2 for March is on track to show year-to-year growth of about 9.6% versus an unrevised 9.9% in February, with month-to-month growth estimated at roughly 0.2%, the same as in February. The early estimate on M1 for March shows year-to-year growth of roughly 17.4%, versus a revised 18.2% (previously 18.3%) in February, with month-to-month change showing a likely contraction of 0.3% in March, versus an unrevised 0.2% contraction in February. The relatively stronger annual growth rates in M1 and M2 continue to reflect an earlier shifting of funds out of M3 accounts into M1 and M2 accounts.

Mounting Stress in the Systemic-Solvency Crisis Will Be the Likely QE3 Trigger; Weak Economic Data Are Just Political Cover. Despite market interpretations of last week's FOMC minutes and broad media commentary last week as to how the "strengthening" economy decreased the odds of the Fed introducing a QE3 round of easing, the underlying reality is being missed. The Fed's prior easings have been attributed to the need for action to offset the weak economy, but there is little the Fed can do to help the economy, and Mr. Bernanke knows that. The Fed's easings all have been aimed primarily at preventing a banking-system collapse. Accordingly, as the system falters anew, QE3 will follow, although for popular political considerations, the Fed's actions once again will be blamed on the economy. From the Fed's standpoint, systemic survival is all that matters. Economic growth and inflation rates very much are lagging, secondary concerns. Accordingly, today's weaker payroll data (and other likely downside economic reporting surprises in the weeks ahead) could provide needed cover for the next round of easing.

REPORTING DETAIL

EMPLOYMENT AND UNEMPLOYMENT (March 2012)

Employment Data Show Minimal Catch-Up. Reporting of monthly changes in payroll employment and the unemployment rate remains unstable, unreliable and inconsistent. As discussed in the *Opening Comments and Executive Summary*, the weaker-than-consensus payroll number likely included some seasonal correction from an unseasonably warm winter, but the bulk of the "weakness" more likely was just some catch-up in unstable seasonally-adjusted reporting of recent months. Unfortunately, the

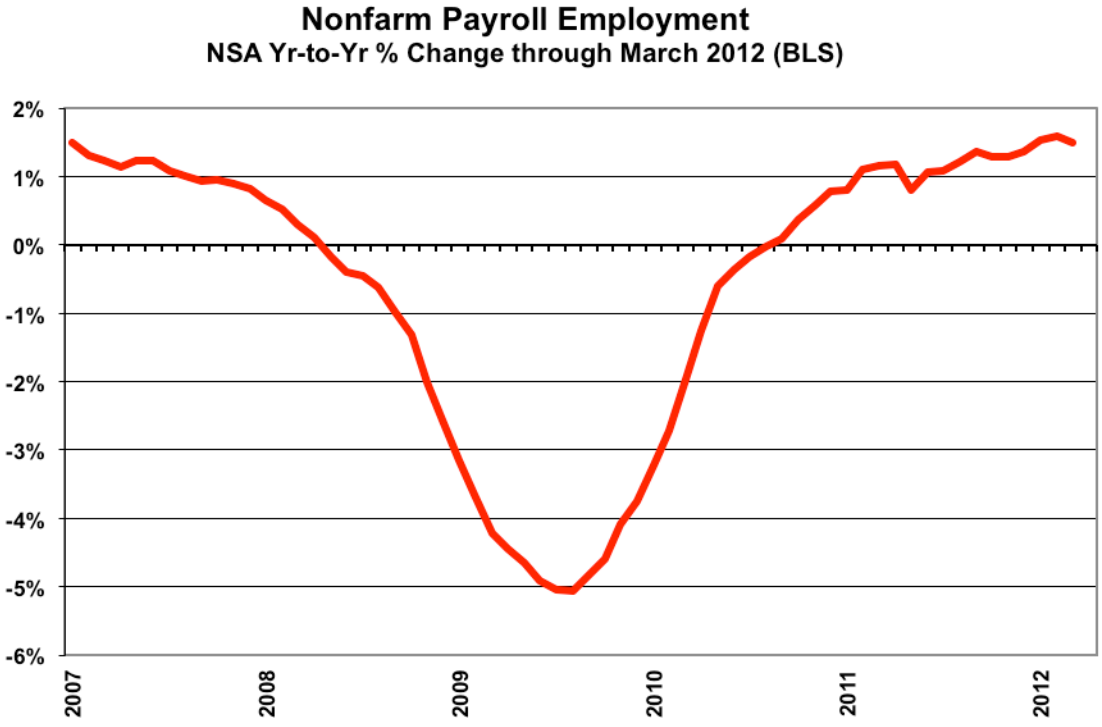
seasonal-adjustment process still remains seriously marred by the unusual length and depth of the current economic downturn, and that leaves the resulting headline labor numbers of highly questionable quality.

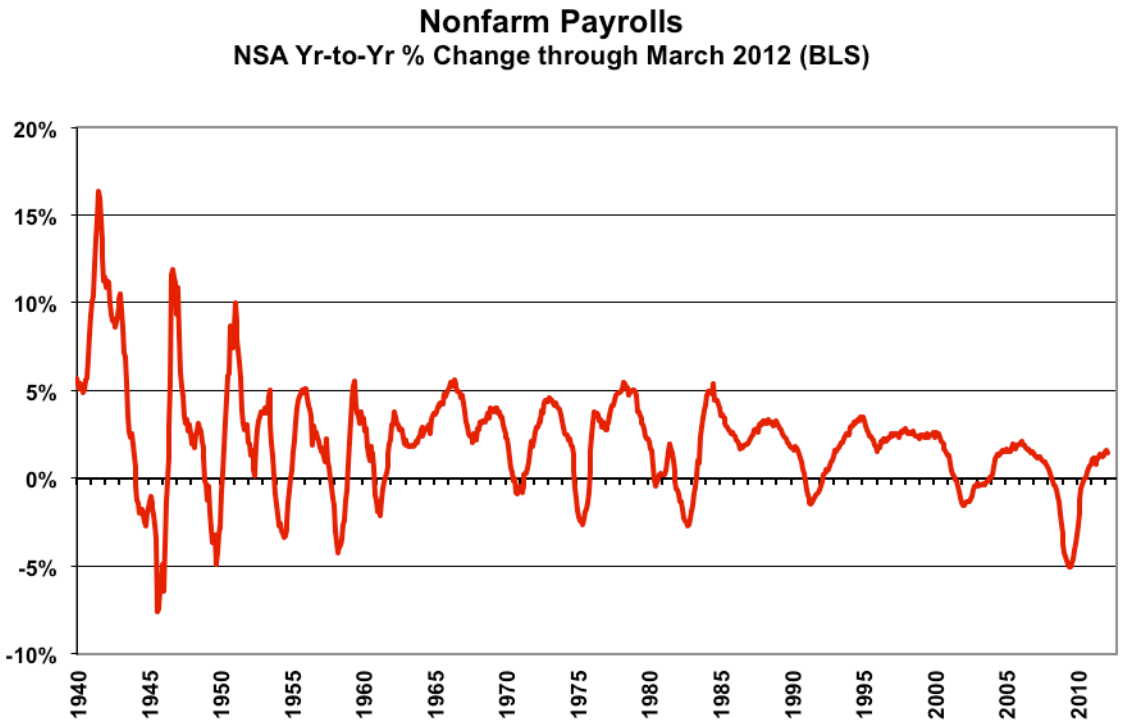
That said, the general outlook has not changed. Payrolls still remain well shy of recovering their pre-2007 recession highs, and headline unemployment reflects less than half the total individuals who would consider themselves unemployed. The difference remains that headline unemployment does not consider the still-swelling ranks of those who desire work, could and would take a job, but have given up looking for work because there are no jobs to be had.

PAYROLL SURVEY DETAIL. The BLS reported today (April 6th) a statistically-insignificant, seasonally-adjusted March 2012 month-to-month payroll employment gain of 120,000 (a gain of 124,000 jobs before prior period-revisions) +/- 129,000 (95% confidence interval). The February payroll gain was revised to 240,000 (previously 227,000).

In terms of year-to-year change, the unadjusted March 2012 annual growth rate was 1.50%, minimally softer than the revised annual February growth rate of 1.59% (previously 1.56%).

The following graphs of year-to-year unadjusted payroll change had shown a rising trend in annual growth through 2010, which primarily reflected the still-protracted bottom-bouncing in the payroll series. That pattern of growth flattened out in 2011, as shown in the first graph of the near-term detail in year-to-year change. The softer March 2012 number most likely reflected some corrective adjustment to the somewhat stronger data seen in the December to February period.





As shown in the longer-term graph (historical detail back to World War II), with the bottom-bouncing of recent years, current annual growth has recovered from the post-World War II record 5.06% decline in August 2009, which was the most severe annual contraction seen since the production shutdown at the end of World War II (a trough of a 7.59% annual contraction in September 1945). Disallowing the post-war shutdown as a normal business cycle, the August 2009 annual decline remains the worst since the Great Depression, yet the current level of employment is far from any recovery.

The regular graph of seasonally-adjusted payroll levels, which shows the current employment level well below its pre-2007 recession peak, is located in the *Opening Comments and Executive Summary* section.

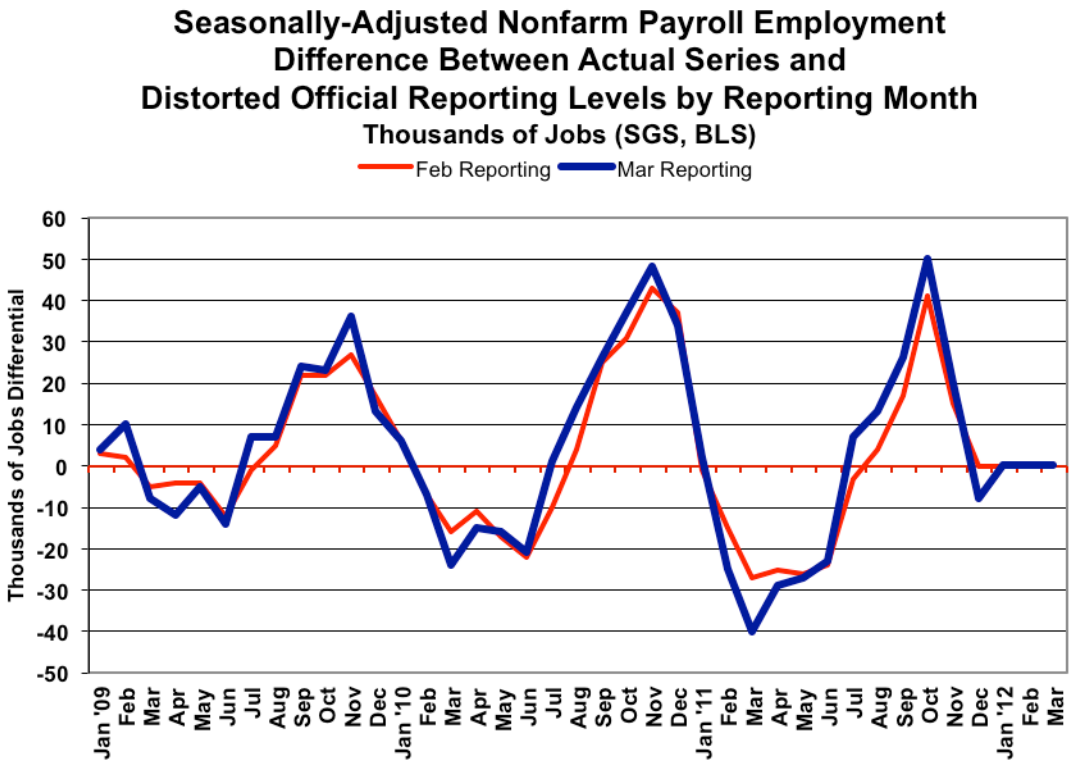
Concurrent Seasonal Factor Distortions. The latest BLS internal estimates should show month-to-month gains in seasonally-adjusted December 2011 payrolls of 195,000 and in January 2012 payrolls of 283,000, but the published numbers are 223,000 for December and 275,000 for January. The first set of numbers is the actual BLS estimate, based on seasonal factors that were recalculated along with March's estimation. Despite revisions in the monthly data each month that go back years, the BLS only publishes two months of revisions with each release (January and February in the current instance), so as not to confuse data users. As a result, the reported January-through-March seasonally-adjusted payroll data are not consistent with earlier reporting. Conceivably, the shifting and unstable seasonal adjustments could move 50,000 jobs or more from earlier periods and insert them into the current period as new jobs, without there being any overt evidence of that happening.

Incomplete and Inconsistent BLS Payroll Reporting. Two months have passed since the annual benchmark revisions to payroll employment, and the latest concurrent seasonal factors show renewed

misreporting of the BLS's own historical payroll levels, as well as ongoing instabilities in the BLS's seasonal factors.

As discussed in prior writings (see *Hyperinflation 2012*, for example), seasonal-factor estimation for most economic series has been distorted severely by the extreme depth and duration of the economic contraction. These distortions are exacerbated for payroll employment data based on the BLS's monthly seasonal-factor re-estimations and lack of full reporting.

Where the BLS recalculates the monthly seasonal factors each month for payroll employment, going back a number of years, outside of benchmarks, it only publishes the revised data for the last two months of reporting. The benchmark revision that accompanied the release of January 2012 payrolls, in theory, included a full update of the revised concurrent seasonally-adjusted data (actually it is off by a month or two). As plotted below, though, the latest revised (but not published) adjusted payroll data already are showing increasingly volatile, monthly seasonal-adjustment distortions of up to 50,000 jobs per month, with previously-reported payroll employment being shifted from the first-half to the second-half of the year. If seasonal-adjustment factors were stable in month-to-month reporting, which they should be, then the graph of differences would be flat and at zero.



A further big issue remains that the month-to-month seasonally-adjusted payroll data have become increasingly worthless, with reporting errors likely now well beyond the official 95% confidence interval

of +/- 129,000 jobs in the reported monthly payroll change. Yet the media and the markets tout the data as meaningful, usually without question or qualification.

Birth-Death/Bias Factor Adjustment. Despite the ongoing and regular overstatement of monthly payroll employment—as evidenced usually by regular and massive, annual downward benchmark revisions (2011 excepted)—the BLS generally adds in upside monthly biases to the payroll employment numbers. The process was created simply by adding in a monthly "bias factor," so as to prevent the otherwise potential political embarrassment of the BLS understating monthly jobs growth. The "bias factor" process resulted from an actual such embarrassment, with the underestimation of jobs growth coming out of the 1983 recession. That process eventually was recast as the now infamous Birth-Death Model (BDM), which purportedly models the effects of new business creation versus existing business bankruptcies.

The March 2012 bias was a positive 90,000, versus a positive 91,000 in February. The aggregate upside bias for the last 12 months was 491,000, or a monthly average of 41,000 jobs created out of thin air, on top of some indeterminable amount of other jobs that are lost in the economy from business closings. Those losses simply are assumed away by the BLS as part of the BDM, as discussed below.

Problems with the Model. The aggregated upside annual reporting bias in the BDM reflects an ongoing assumption of a net positive jobs creation by new companies versus those going out business. Such becomes a self-fulfilling system, as the upside biases boost reporting for financial-market and political needs, with relatively good headline data, while often also setting up downside benchmark revisions for the next year, which traditionally are ignored by the media and the politicians. Where the BLS cannot measure the impact of jobs loss and jobs creation from employers starting up or going out of business, on a timely basis (within at least five years, if ever), such information is estimated by the addition of a bias-factor generated by the BDM.

Positive assumptions—commonly built into government statistical reporting and modeling—tend to result in overstated official estimates of general economic growth. Along with happy guesstimates, there usually are underlying assumptions of perpetual economic growth in most models. Accordingly, the functioning and relevance of those models become impaired during periods of economic downturn, and the current downturn has been the most severe—in depth as well as duration—since the Great Depression.

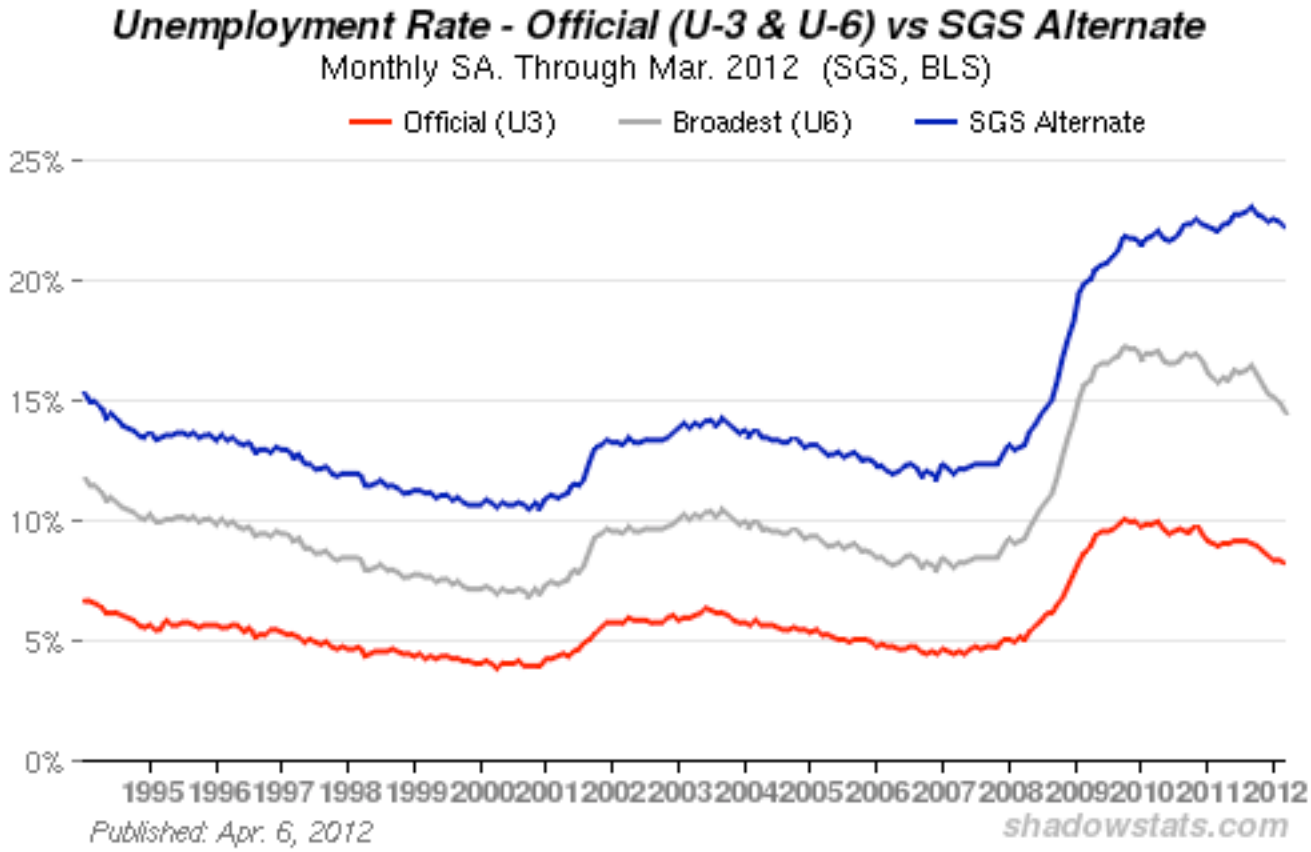
Indeed, historically, the BDM biases have tended to overstate payroll employment levels—to understate employment declines—during recessions. There is a faulty underlying premise here that jobs created by start-up companies in this downturn have more than offset jobs lost by companies going out of business. So, if a company fails to report its payrolls because it has gone out of business, the BLS assumes the firm still has its previously-reported employees and adjusts those numbers for the trend in the company's industry.

Further, the presumed net additional "surplus" jobs created by start-up firms, get added on to the payroll estimates each month as a special add-factor. These add-factors are set now to add an average of about 41,000 jobs per month in the current year, but the actual overstatement of monthly jobs likely exceeds that number by a significant amount. With the underlying economy continuing to falter, I expect a significant downside benchmark revision for 2012 (based on the upcoming March 2012 benchmark), given current details of the BLS's overly positive estimates. We are developing in-depth analyses of both the BLS's seasonal-adjustment modeling and benchmarking process, which should be published in the near future.

HOUSEHOLD SURVEY DETAILS. The once 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 more than once) showed a monthly employment decline in March 2012 of 31,000, following a gain in February of 428,000.

Note: Severe issues with monthly seasonal factors are ongoing and meaningfully cloud the significance of the reported monthly levels in the adjusted headline U.3 unemployment rate and other adjusted household-survey numbers. The data have been shifted by highly unstable seasonal factors that are artifacts of the severe and extraordinarily protracted downturn in U.S. economic activity (as well as distortions created by 2010's census hiring and firing effects), not by the regular and stable seasonal patterns that were in place before the current economic crisis. Unlike the payroll or establishment series, the household survey does not use the concurrent seasonal factor adjustment series.

Unemployment Rates. The reported March 2012 seasonally-adjusted headline (U.3) unemployment rate declined by a statistically-insignificant 0.08 percentage point to 8.19% +/- 0.23%, versus February's reported 8.27%. On an unadjusted basis, March's U.3 unemployment rate was 8.4%, versus February's 8.7%.



With the accounting for those working part-time due to economic reasons still heavily skewed by bad seasonal factors, the March U.6 unemployment rate dropped to a seasonally-adjusted 14.5%, from 14.9% in February. The unadjusted March U.6 rate declined to 14.8% from 15.6% in February.

The broadest unemployment rate published by the BLS, U.6 includes accounting for those marginally attached to the labor force (including short-term discouraged workers) and those who are employed part-time for economic reasons (they cannot find a full-time job).

In 1994, during the Clinton Administration, "discouraged workers"—those who 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 long-term discouraged workers. The remaining short-term discouraged workers (less than one year) are included in U.6.

Adding the SGS estimate of excluded long-term discouraged workers back into the total unemployed and labor force, unemployment—more in line with common experience as estimated by the SGS-Alternate Unemployment Measure—notched lower to 22.2% in March from 22.4% in February. The SGS estimate generally is built on top of the official U.6 reporting, and tends to follow its relative monthly movements. Accordingly, the SGS measure will suffer some of the current seasonal-adjustment woes afflicting the base series, such as recent distortions in adjusted reporting of part-time employment for economic reasons. There still should be catch-up reporting in the months ahead, since the series do not use the concurrent-seasonal-factor methodology that is used with the payroll employment series.

Nonetheless, there continues to be a noticeable divergence in the SGS series versus U.6. The reason for this is that U.6, again, only includes discouraged workers who have been discouraged for less than a year. As the discouraged-worker status ages, those that go beyond one year, fall off the government counting, and new workers enter "discouraged" status. Accordingly, with the continual rollover, the headline workers flow into the short-term discouraged workers counted in U.6 continue, and from U.6 into long-term discouraged worker status (SGS Measure) at what appears to be an accelerating pace. See the Alternate Data tab for more detail.

As discussed in previous writings, an unemployment rate above 22% might raise questions in terms of a comparison with the purported peak unemployment in the Great Depression (1933) of 25%. The SGS level likely is about as bad as the peak unemployment seen in the 1973 to 1975 recession. The Great Depression unemployment rate was estimated well after the fact, with 27% of those employed working on farms. Today, less that 2% work on farms. Accordingly, for purposes of Great Depression comparison, I would look at the estimated peak nonfarm unemployment rate in 1933 of 34% to 35%.

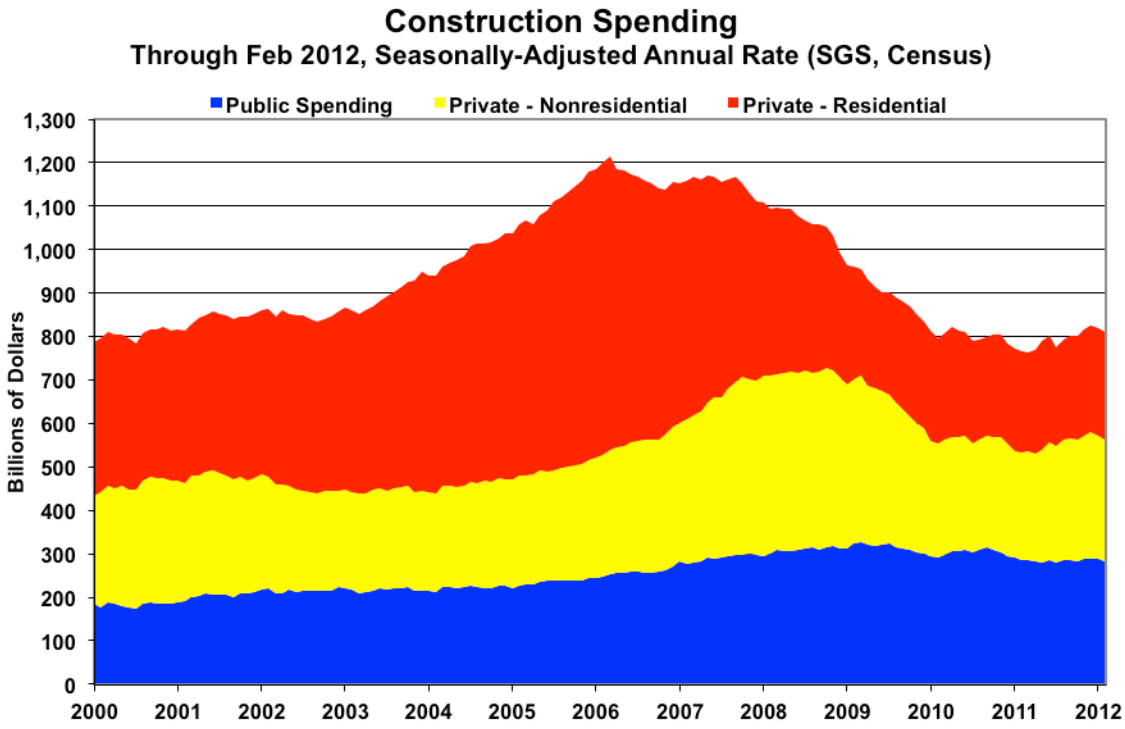
CONSTRUCTION SPENDING (February 2012)

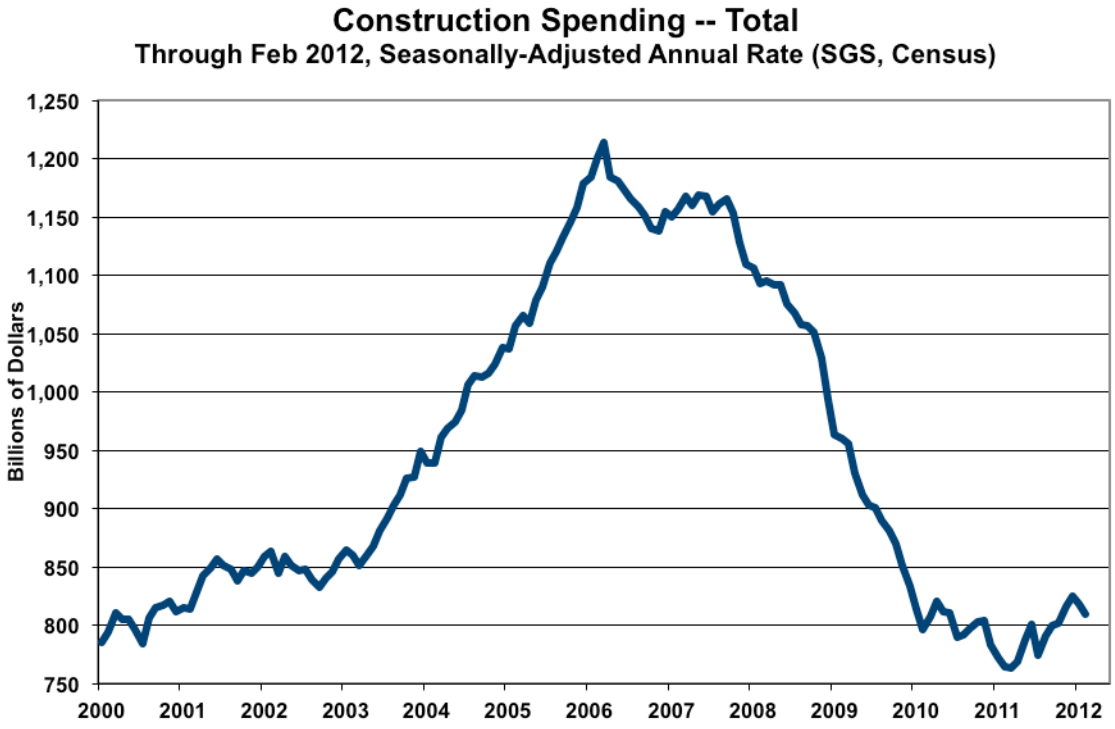
February Construction Spending Dips, After Downside Revisions to January. Construction activity remains severely impaired—stagnant near the cycle lows—as discussed previously in *Commentary No. 425*. The Census Bureau reported on April 2nd that the total value of construction put in place in the United States during February 2012 was $808.9 billion, on a seasonally-adjusted—but not inflation-adjusted—annual-rate basis. That estimate was down by a statistically-insignificant 1.1% (down by 2.2%, net of prior period revisions) +/- 1.5% (all confidence intervals are at a 95% level) from a revised $818.1 billion (previously $827.0) in January. In turn, January showed a revised 0.8% (previously 0.1%) decline

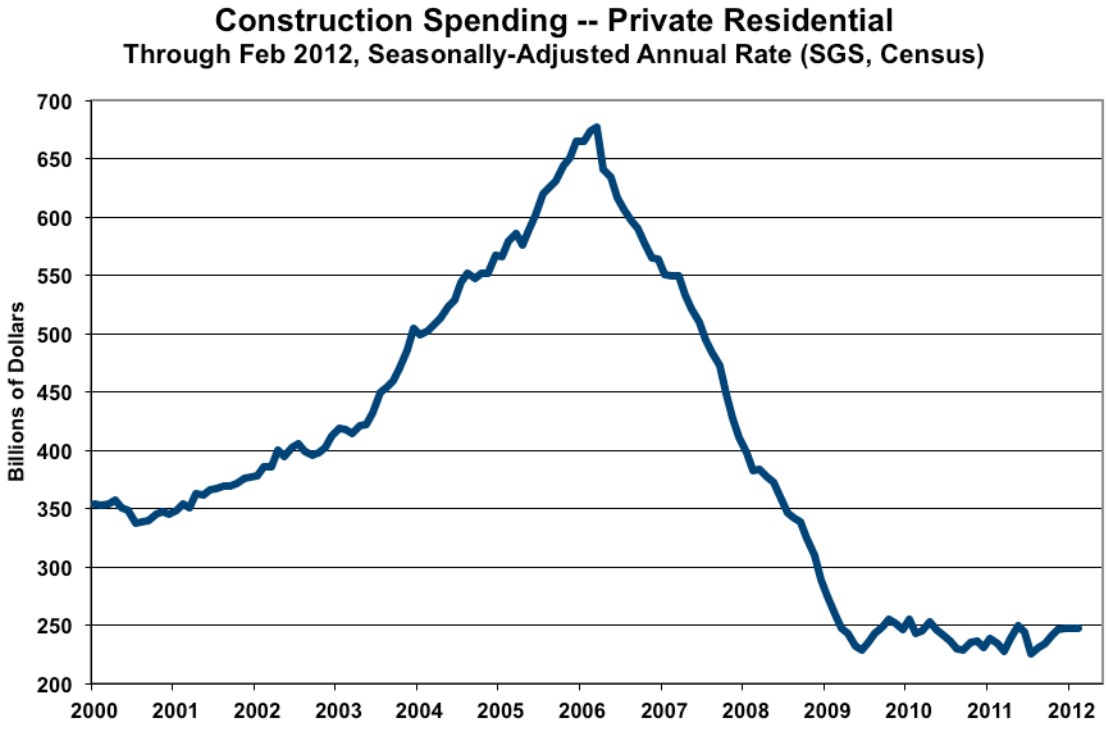
from December 2011. Although construction was up by a statistically-significant 5.8% +/- 2.1% in February, the gain likely was more than covered by increases in construction costs. Year-to-year, January construction was up by a revised 6.0% (previously 7.1%).

As reflected in the accompanying graphs, on a monthly basis February private construction fell by 0.8% (2.1% before prior-period revisions), with residential construction unchanged (down by 2.8% before prior-period revisions), and with nonresidential construction down by 1.6% (down by 1.5% before prior-period revisions). February public construction for the month declined by 1.7% (down by 2.3% before prior-period revisions)

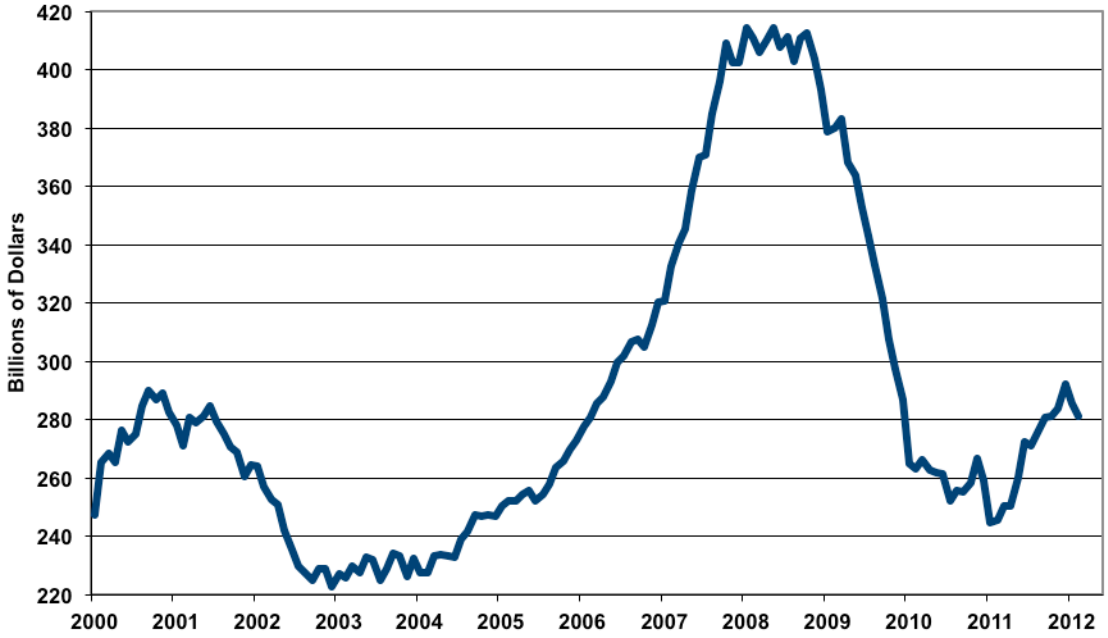
The annual benchmark revision for the series is due for release on July 2, 2012.



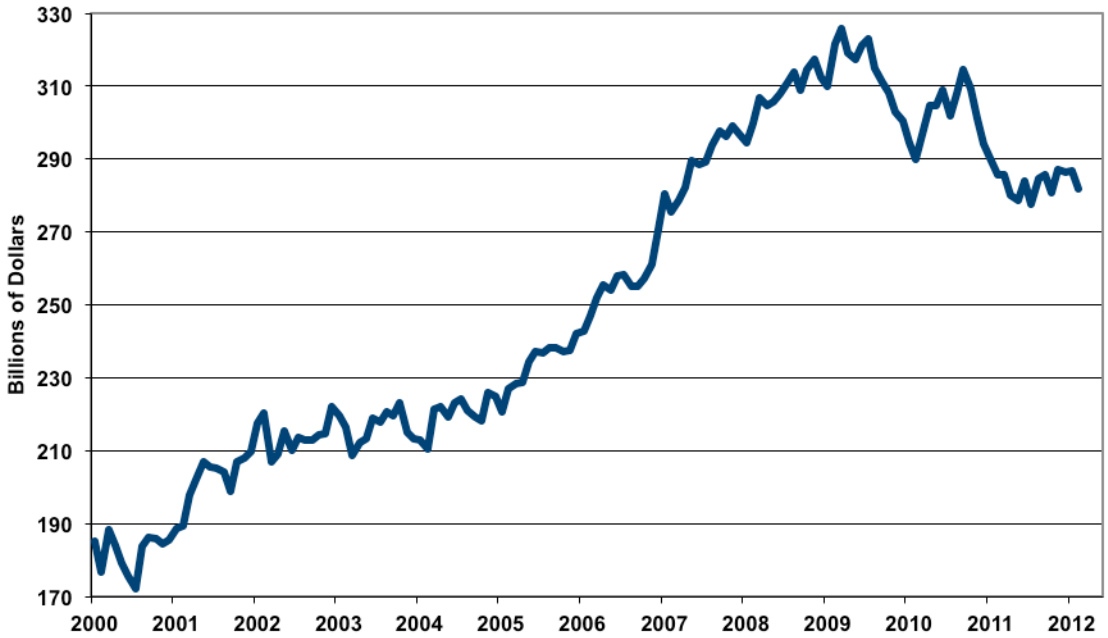




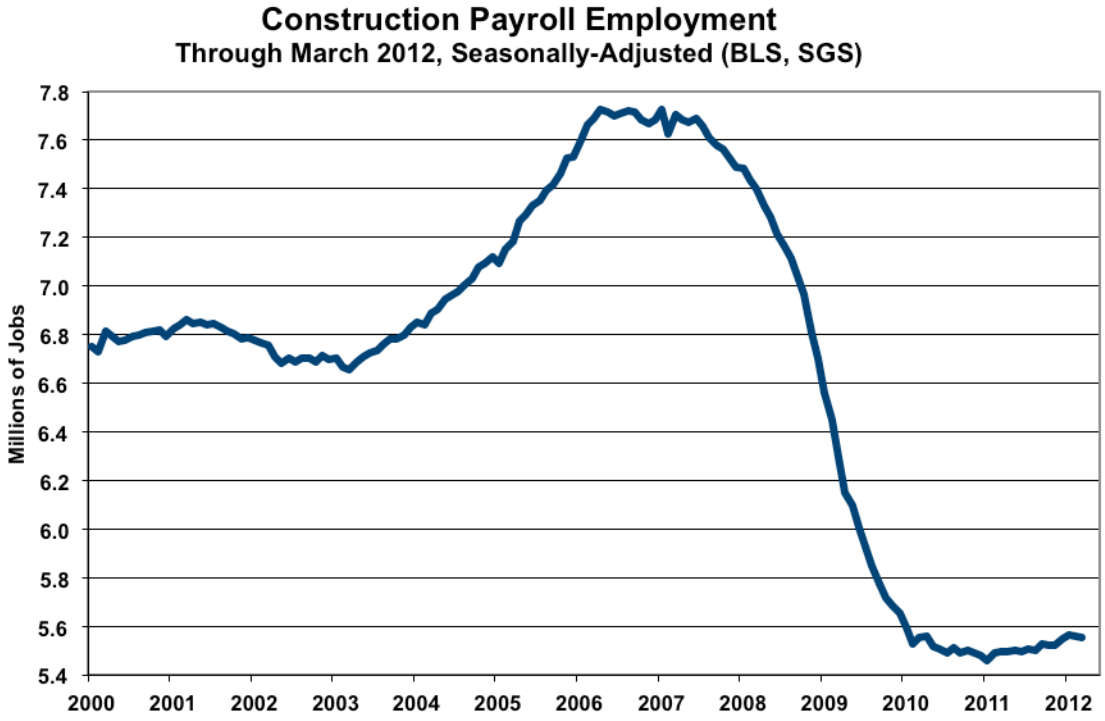
Construction Spending -- Private Nonresidential
Through Feb 2012, Seasonally-Adjusted Annual Rate (SGS, Census)



Construction Spending -- Public Spending
Through Feb 2012, Seasonally-Adjusted Annual Rate (SGS, Census)



In line with the ongoing bottom-bouncing reported through February in construction spending, and suggestive of that pattern having continued in March, seasonally-adjusted March construction employment remained stagnant. Construction jobs purportedly dropped by 7,000 to a level of 5.551 million, per today's labor data report.



Week Ahead. Recognition of an intensifying double-dip recession as well as an escalating inflation problem remains sporadic. The political system would like to see the issues disappear until after the election; the media does its best to avoid publicizing unhappy economic news; and the financial markets will do their best to avoid recognition of the problems for as long as possible, problems that have horrendous implications for the markets and for systemic stability.

Until such time as financial-market expectations move to catch up fully with underlying reality, or underlying reality catches up with the markets, reporting generally will continue to show higher-than-expected inflation and weaker-than-expected economic results in the months and year ahead. Increasingly, previously unreported economic weakness should show up in prior-period revisions.

Trade Balance (February 2012). Detail on the February U.S. trade deficit is scheduled for release on Thursday, April 12th. This will be the final trade release available before the "advance" GDP estimate for first-quarter 2012 is released on April 27th. Accordingly, a major surprise would tend to impact expectations for GDP growth. A likely larger than expected deterioration, or worse than expected improvement, would dampen the consensus outlook of GDP activity.

Producer Price Index—PPI (March 2012). The March 2012 PPI inflation estimate is due for release on Thursday, April 12th. Seasonal factors will shift to heavily depressing oil-price inflation in March. Even so, sharply rising oil costs and related upside inflationary pressures in the broad economy offer upside risk to a consensus outlook for 0.1% monthly decline the PPI, per MarketWatch.com.

Consumer Price Index—CPI (March 2012). The March 2012 CPI inflation estimate is due for release on Friday, April 13th. As with the PPI, gasoline-price seasonal adjustments will dampen actual energy inflation in March, but the sharp increase in energy costs, along with the spreading inflation effects in the rest of the economy also suggest an upside reporting surprise here, versus the consensus. Per MarketWatch.com, the consensus is for a 0.2% monthly increase in the CPI-U.

Gasoline prices rose 7.3% for the month, per the Department of Energy. There also could be some relative pick up in March prices from the BLS having understated unadjusted gasoline price increases in February. In any event, seasonal-adjustments to gasoline prices indeed will constrain reported inflation. In March 2011, an 11.7% increase in monthly gasoline prices was reduced to 5.6%, after seasonal adjustments.

Year-to-year total CPI-U inflation would increase or decrease in March 2012 reporting, dependent on the seasonally-adjusted monthly change, versus the 0.53% gain in the adjusted monthly level reported for March 2011. I use the adjusted change here, since that is how consensus expectations are expressed. To approximate the annual unadjusted inflation rate for March 2012, the difference in March's headline monthly change (or forecast of same) versus the year-ago monthly change should be added to or subtracted directly from February 2012's reported annual inflation rate of 2.87%. A consensus result of a 0.2% monthly increase, for example, would suggest a consistent annual inflation rate of 2.5% to 2.6%, depending on rounding.