John Williams'

Shadow Government Statistics

Analysis Behind and Beyond Government Economic Reporting

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Fed Action, November Retail Sales, PPI, October Trade Deficit

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Fed Moves to Monetize More Treasury Debt,
Boosting the Outlook for Inflation, Not the Economy

Still Hammered by Consumer Illiquidity,
November Retail Sales Reporting Was Warped by Hurricane Effects

Mangled by Soft Revisions to Services Surplus,
October Trade Deficit Likely Also Reflected Storm Distortions

PPI Decline Driven by Temporary Drop in Oil Prices

PLEASE NOTE: The next regular Commentary *is scheduled for tomorrow, Friday, December 14th, covering November industrial production, CPI and related deflated series.*

Best wishes to all — John Williams

Opening Comments and Executive Summary. The Fed's second round of quantitative easing (QE2)—first jawboned and then launched in late-2010—appears, in retrospect, to have been an experiment by the Federal Reserve Chairman Ben Bernanke and the Federal Reserve to see what would happen. QE2 was distinguished from prior and subsequent Fed easings, by the U.S. central bank monetizing a significant amount of U.S. Treasury debt, where purchases from the system actually exceeded net U.S. Treasury issuance of new public debt for some months. With QE2 in full force, the foreign-exchange value of the

U.S. dollar weakened, with a resulting spike in oil prices and an ensuing pick-up in U.S. consumer inflation. Broad money supply showed began to grow and gold prices surged.

Again, though, QE2 likely was an experiment. Yesterday, December 12, 2012, the Federal Reserve expanded QE3 so as to begin monetizing U.S. Treasuries, once again. Now, far from experimental, this renewed monetization of Treasury debt likely will become perpetually expansive, providing unlimited liquidity to a system that already is dependent on, and addicted to the Fed's stimulants. With no economic recovery in place or pending, and with the financial system and markets unable to survive withdrawal symptoms, ever-expanding QE3 likely will continue until such time as the U.S. dollar collapses in a hyperinflation. Effectively, this was a decision that was made at the time of the panic in 2008, in an effort to avert an immediate systemic collapse, to buy some time.

The Federal Open Market Committee (FOMC) announcement detailed an expanded QE3 to include purchases of U.S. Treasury securities in the amount of $45 billion per month (an annualized pace of $540 billion). That annualized pace reflects 47.2% of the net-debt issuance by the U.S. Treasury to the public in fiscal-year 2012 (year-ended September 30th). The Fed remains flexible, able to expand (or reduce) its Treasury purchases as needed. Added monetization, however, will be likely as continued economic contraction causes the federal deficit to balloon beyond expectations, pushing the U.S. Treasury's funding needs to unexpected levels. The Fed stands in reserve, as the lender of last resort, to prevent a failed U.S. Treasury auction, at such time as public and global demand dwindles for the securities.

The expansion of QE3 into other assets (U.S. Treasuries) was allowed "as appropriate," in the FOMC's September 13th initial announcement of the program. While Fed deems renewed action of monetizing Treasury debt as appropriate, the need, as expressed to the public has been masked by the smokescreen of a weakening economy. The problem remains banking-system solvency; 2008 still is playing out. The Fed's purported effort at attacking the weak economy (specifically unemployment), with debt monetization is nothing more than political cover for helping the banks.

In his press conference following the FOMC announcement, Mr. Bernanke clarified that the just-announced 6.5% unemployment rate target was only a guidepost. He admitted quite frankly that the Fed did not have the wherewithal with its actions to reduce the unemployment rate.

Monetization of Treasuries and U.S. Sovereign Solvency Issues Are A Deadly Duo for U.S. Dollar. The expansion of QE3 continued the regular unfolding of events that eventually will trigger a hyperinflation. In response to the QE3 expansion, initial market reactions in U.S. dollar and gold trading appears to have been muted by direct market interventions, possibly coordinated by the President's Working Group on Financial Markets, which has the ability to intervene in any market, at any time, as it deems necessary. Such was discussed by Alan Greenspan when he was Federal Reserve Chairman.

With the Fed's renewed monetization of U.S. Treasury securities in the works, the currency markets, as well as the markets for gold and silver likely will be hypersensitive to the "fiscal-cliff" and debt-ceiling negotiations. As otherwise discussed in *Special Commentary (No. 485)*, the U.S. dollar remains vulnerable to a massive sell-off in the near future. Potential proximal triggers are being pulled or are close to being pulled.

While market interventions are possible, even likely, as dollar-selling pressures increase, those official counteractions usually are directly against underlying, fundamental market forces, which otherwise tend to win out over the longer haul. The best the Fed and the U.S. financial markets could hope for here would be an orderly decline in the foreign-exchange value of the U.S. currency.

Hurricane Sandy Muddies the Water on Some October and November Economic Reporting. For the next month or two, certain economic series may show unusual patterns of activity, because of disruptions and distortions from Hurricane Sandy. Upcoming reporting on November industrial production and residential construction numbers should provide some indications of the storm's impact. In the past couple of days, however, the reported October trade deficit and certainly November retail sales were impacted, but the detail is unknowable at this time, given the nature of the compilation of the series, as discussed in the *Reporting Detail* section. Trade reporting should be back to normal by December. On the retail-sales side, negative impact from the disruptions should be out of the system fairly quickly, but the effects of temporary gains from replacement purchases of lost or damaged goods and products could linger into the first-quarter or so of 2013.

November Retail Sales. November 2012 retail sales showed a statistically-insignificant, headline monthly gain of 0.27% (a gain of 0.20% before prior-period revisions), versus a revised monthly decline of 0.34% (previously 0.31%) in October. Year-to-year November 2012 retail sales held at 3.70%, versus a revised 3.70% (previously 3.83%) in October.

After the release of November's CPI-U inflation details, tomorrow, the real (inflation-adjusted) monthly sales gain should be somewhat stronger, given a likely monthly decline in the CPI (subtracting a negative inflation number), but the real year-to-year change likely will continue at a level that historically has indicated a pending recession, with a high degree of reliability, during normal economic times.

October Trade Deficit. The headline trade deficit in goods and services for October 2012 widened to $42.2, from a revised $40.3 (previously $41.5) in September, while narrowing from a $45.7 billion deficit the year before. These numbers were in the context of revisions to the last six months of trade data, which reflected narrower monthly deficits, in revision, thanks primarily to large upside revisions to the services surpluses, leaving the merchandise deficits largely intact. The services data generally are guesstimated.

November Producer Price Index (PPI). The headline finished-goods PPI for November 2012 fell by 0.76% (down by 0.92% unadjusted), following a monthly decline of 0.15% (down by 0.20% unadjusted) in October. The monthly change largely reflected a temporary decline in oil and related gasoline prices, with minimal offset from related monthly seasonal adjustment factors.

Year-to-year, finished-goods PPI inflation slowed to 1.46% in November, from 2.35% in October. Annual "core" inflation (net of food and energy inflation), however, turned higher in November, to 2.17%, from 2.11% in October, reflecting the impact of ongoing high oil prices.

[For more details on retail sales, PPI and the trade deficit see the* Reporting Detail *section.]

HYPERINFLATION WATCH

The *Special Commentary (No. 485)*, published on November 27th, updated *Hyperinflation 2012* and the broad outlooks on the economy and inflation, as well as systemic stability and the U.S. dollar. Where none of the economic releases of the past two weeks, and certainly no advertised negotiating activity by

Washington politicians on the "fiscal cliff" and debt ceiling expansion, have altered those outlooks, the expansion of QE3 by the Fed yesterday, December 12th, continued the regular unfolding of events that eventually will trigger a hyperinflation, as discussed in the *Opening Comments.*

The Fed's activity can be viewed as a signal of deepening problems in the banking system. As discussed yesterday by Mr. Bernanke, the Fed can do little to stimulate the economy. Direct monetization of Treasury debt, however, will tend to savage the U.S. dollar's exchange rate, boost oil and gasoline prices, boost money supply growth and domestic U.S. inflation.

For new subscribers, as well as for those who otherwise are not familiar with hyperinflation report or recent the special commentary, linked above, those documents are suggested as background reading on the financial turmoil and currency upheaval facing the United States in the next year or two.

REPORTING DETAIL

RETAIL SALES (November 2012)

Hurricane Sandy Certainly Had Impact on November Retail Sales, But Detail Is Unknowable at Present, Based on Census Bureau Surveying. While the 0.3% headline gain in November retail sales was affected by the hurricane, what was lost in activity due to business disruption (such as closed gasoline stations) and what was gained in activity from replacement of damaged goods (such as in automobile sales), cannot be broken out in the current national surveying by the Census Bureau. One likely upside and outright distortion to the November data, though, is in sampling assumptions.

Like the Bureau of Labor Statistics with its payroll survey, the Census Bureau assumes that a non-reporting company still is in business and just didn't get around to filing its sales report on a timely basis. So, where damaged businesses were not able to participate in regular surveying, the Census Bureau estimated what it felt the missing sales reporting should have been, and those numbers were added into the headline reporting.

Beyond storm-related impact and a continued declined in national gasoline prices, November retail sales also were subject to ongoing spending constraints from continued impairments to consumer liquidity. The chances for sustainable, real (inflation-adjusted) gains in retail sales remain nil, where the consumer lacks adequate income growth and credit availability to fund ongoing increases in real consumption, as discussed in *Special Commentary (No. 485)*.

Note: The stability of the seasonal-adjustment process (particularly the concurrent seasonal-adjustment process used with retail sales) and of sampling methods has been disrupted severely by the unprecedented depth and length of the current economic downturn in the post-World War II era (the period of modern economic reporting), as well as temporarily from the impact of Hurricane Sandy. Under such circumstances, where the markets effectively are flying blind as to actual economic activity, consideration of broad underlying fundamentals is essential. Consumer income and credit remain structurally impaired, as discussed recently in Hyperinflation 2012 *and* Special Commentary (No. 485).

Nominal (Not-Adjusted-for-Inflation) Retail Sales. This morning's (December 13th) report on November 2012 retail sales—issued by the Census Bureau—indicated a statistically-insignificant, seasonally-adjusted monthly gain of 0.27% (a gain of 0.20% before prior-period revisions) +/- 0.6% (all confidence intervals are at the 95% level), versus a revised monthly decline of 0.34% (previously 0.31%) in October.

Year-to-year November 2012 retail sales held at 3.70% +/- 0.6%, versus a revised 3.70% (previously 3.83%) in October.

Core Retail Sales. In November, monthly grocery-store sales fell by 0.51%, while gasoline-station sales sank by 4.00%, reflecting lower gasoline prices and some undetermined level of storm effects. Under normal conditions, 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: November 2012 versus October 2012 seasonally-adjusted retail sales series—net of total grocery store and gasoline station revenues—was up by 1.02%, versus the official gain of 0.27%.

Version II: November 2012 versus October 2012 seasonally-adjusted retail sales series—net of the monthly change in revenues for grocery stores and gas stations—was up by 0.79%, versus the official gain of 0.27%.

Real (Inflation-Adjusted) Retail Sales. With headline November CPI inflation likely to be a negative number, real month-to-month growth in November retail sales should be stronger than the 0.27% headline number in today's nominal retail sales reporting. Nonetheless, annual real retail sales growth, as of November, still should continue at a low level, which would be generating a strong signal of pending recession during normal economic times. The inflation-adjusted retail sales details will be detailed in tomorrow's (December 14th) *Commentary*, which will cover the release of November 2012 CPI-U.

PRODUCER PRICE INDEX—PPI (November 2012)

Year-to-Year "Core" Wholesale Inflation Inches Higher. As reported this morning, December 13th, by the Bureau of Labor Statistics (BLS), the regularly-volatile, seasonally-adjusted finished-goods producer price index (PPI) for November 2012 fell by 0.76% (down by 0.92% unadjusted), following a monthly decline of 0.15% (down by 0.20% unadjusted) in October. The monthly change largely reflected a temporary decline in oil and related gasoline prices, with minimal offset from related monthly seasonal adjustment factors.

The rounded 0.8% seasonally-adjusted decline reported in headline monthly inflation for November was accounted for by an adjusted 4.6% (unadjusted 5.3%) month-to-month decline in finished energy goods, plus an adjusted 1.3% (unadjusted 1.3%) gain in food prices and by an adjusted 0.1% (unadjusted 0.1%) gain in "core" inflation.

"Core" inflation is net of food and energy inflation. The concept of core inflation as a realistic measure of full inflation is nonsensical, where food and energy account for 41.4% of the finished goods PPI (24.6% of the CPI-U, 27.6% of the CPI-W). Even Mr. Bernanke, core-inflation's primary advocate at present, purportedly consumes food and energy.

That said, the core measure, is useful as an indication of how energy prices (in particular) are impacting the broad economy. For November, the seasonally-adjusted month-to-month core PPI was up by 0.11% (up by 0.11% unadjusted) versus October, which, in turn, was down by 0.22% (up by 0.66% unadjusted) from September. Year-to-year, unadjusted core finished goods inflation inched higher to 2.17% in November, versus 2.11% in October. A comparison of core PPI with core CPI-U for November will be graphed in the December 14th *Commentary*.

Unadjusted and year-to-year, November's total finished-goods PPI slowed to 1.46% annual inflation, from preliminary reporting of 2.35% in October. Annual change in the PPI has weakened from a 7.08% near-term peak seen in July 2011, after which the annual numbers began going against a year-ago period where Mr. Bernanke was running QE2, meeting with early success in debasing the U.S. Dollar and generating an increase in oil prices. QE3's impact, so far, has been minimal, from jawboning, not from specific monetary action, with oil prices seeing mixed pressure, due partially to Middle-East political tensions. That should change fairly quickly, as the expanded QE3 and the renewed monetization of U.S. Treasuries begin to hit the U.S. dollar, intensifying upside pressures on oil prices.

Intermediate and Crude Goods. On a monthly basis, seasonally-adjusted November intermediate goods prices fell by 1.2%, following a 0.1% decline in October, with November crude goods prices up by 0.1%, following an October increase of 0.9%.

Year-to-year inflation in unadjusted November intermediate goods fell by 0.3%, following an increase of 0.8% in October. Year-to-year deflation in October crude goods widened to an annual decline of 1.8% in November, following a 0.2% annual decline in prices in October.

U.S. TRADE BALANCE (October 2012)

Revisions—Narrowing Most-Recent Six Months of Deficit—Reflected Upside Revisions to Gimmicked Services Numbers. October trade deficit reporting was the first trade estimate that could have reflected disruptions to the flow of trade and trade-related paperwork through the Port of New York, and surrounding areas, from Hurricane Sandy. While trade and reporting flows likely will be stabilized by the time of December's reporting, the October number and particularly next month's November number could show misleading variability in the headline numbers.

That said, the biggest clear distortion to the October trade report had nothing to do with bad weather, but rather with poor quality estimates in the services sector. The monthly trade balance reflects both goods and services, where goods run regularly in severe deficit, while the nebulous "services" estimate shows regular surpluses.

The problem here is that there is a hard paper trail on the merchandise, or goods side, but the services side largely is estimated and largely guessed at by the same people who decided to start reporting the "soft" services number along with the "hard" merchandise number, just to make the headline monthly trade numbers look a little more politically palatable than they would have with the just the reporting of the deteriorating merchandise sector.

The six months worth of revisions published with the October report showed an and accelerating pace of upside revision to the prior reporting of the monthly services surplus (with generally higher exports, and lower imports), with the August and September surpluses revised higher, respectively, by 7.9% and 7.2%.

Nominal (Not-Adjusted-for-Inflation) Trade Deficit. The Bureau of Economic Analysis (BEA) and the Census Bureau reported December 11th that the nominal, seasonally-adjusted monthly trade deficit in goods and services for October 2012, on a balance-of-payments basis, widened to $42.2, from a revised $40.3 (previously $41.5) in September. The October 2012 deficit narrowed from a $45.7 billion deficit in October 2011. These numbers were in the context of revisions to the last six months of trade data, which reflected a narrowed deficit, in revision, thanks primarily to large upside revisions to the services surplus, leaving the merchandise deficits largely intact. The services data generally are guesstimated.

<u>Crude Oil and Energy-Related Petroleum Products</u>. For the month of October 2012, the not-seasonally-adjusted average price of imported oil rose to $99.75 per barrel, from $98.88 in September 2012, and it was up from an average $98.87 in October 2011.

In terms of not-seasonally-adjusted physical oil imports, October 2012 volume averaged 8.376 million barrels per day, up from 8.222 million in September 2012, but it was down from 8.445 million barrels per day in October 2011.

<u>Other Cautions on Data Quality.</u> Beyond possible short-lived disruptions from weather impact, the standard caution here for the monthly detail is that heavy distortions likely also continue in the seasonal adjustments, much as has been seen in other economic releases, such as retail sales and payrolls, where the headline number reflects month-to-month change. As has been discussed frequently (see Hyperinflation 2012 *for example), the extraordinary length and depth of the current business downturn have disrupted regular seasonality patterns. Accordingly, the markets should not rely heavily on the accuracy of the monthly headline data.*

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 October 2012 merchandise trade deficit (no services) came in at $46.2 billion, versus a revised $46.6 (previously $46.8) in September. October 2012, however, was unchanged at the first decimal point versus the October 2011 estimate of $46.2 billion.

With a small revision to the full third-quarter 2012 merchandise trade estimate, the real third-quarter deficit now annualizes out at $567.2 billion (previously $568.2 billion), versus an annualized second-quarter 2012 pace of $563.5 billion. With the initial October number annualizing to $554.0 billion, as a proxy for the fourth-quarter number, it is too early to suggest the likely impact on the upcoming fourth-quarter GDP growth (end of January), given the relatively small quarterly change suggested by the October numbers and the relatively large potential variability that could be seen with the November numbers, which will be used in the determining the "advance" estimate of the fourth-quarter GDP.

Week Ahead. Business activity reflected in November reporting should tend to reflect more-negative distortions than did October, in the wake of the damage and business disruptions from Hurricane Sandy. Some of that impact should turn temporarily positive by December, with rebuilding of facilities and replacement of goods damaged or destroyed in the unusually severe late-October tempest.

Otherwise, in terms of general economic activity, until such time as financial-market expectations catch up fully with underlying reality, or underlying reality catches up with the markets, reporting generally should continue to show higher-than-expected inflation and indicate weaker-than-expected economic results in the months and year ahead. Increasingly, previously unreported economic weakness should continue to show up in prior-period revisions, as seen recently, for example, in the reporting of October retail sales, industrial production, housing starts, new- and existing-home sales, new orders for durable goods, and November payroll employment.

Significant reporting-quality problems continue with most widely followed series. Headline reporting issues are tied largely to systemic distortions of seasonal adjustments, distortions that have been induced by the still-ongoing economic turmoil of the last five years. The recent economic collapse has been without precedent in the post-World War II era of modern economic reporting. These distortions have thrown into question the statistical-significance of the headline month-to-month reporting for many popular economic series. In any event, where numbers are too far removed from common experience, they tend to be viewed by the public with extreme skepticism.

Still, recognition of an intensifying double-dip recession continues to gain, while recognition of a mounting inflation threat has been rekindled a bit by recent Fed monetary policies and rising headline inflation numbers. The political system would like to see the issues disappear; the media does its best to avoid publicizing unhappy economic news or, otherwise, it puts a happy spin on the numbers; and the financial markets 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.

Consumer Price Index—CPI (November 2012). The release by the Bureau of Labor Statistics (BLS) of the November 2012 CPI numbers is scheduled for tomorrow, Friday, December 14th. Headline CPI inflation rate is due for a contraction on a monthly basis, and for some slowdown on an annual basis. Seasonally-unadjusted monthly-average gasoline prices declined by 7.6% in November, per the Department of Energy, and that monthly decline will be exacerbated in BLS calculations by negative seasonal adjustments. In November 2011, an unadjusted 1.1% monthly decline in November gasoline prices became a 2.4% decline after seasonal adjustment. Without offsets, the adjusted decline in gasoline prices would be worth about a 0.4% monthly drop in the CPI-U.

Given upside pressures from both food and core inflation, however, there is some chance of the headline number being less-negative than developing market expectations, which appear to have settled around a 0.2% month-to-month decline

Year-to-year, CPI-U inflation would increase or decrease in the November 2012 reporting, dependent on the seasonally-adjusted monthly change, versus the 0.09% gain in the adjusted monthly level reported for November 2011. I use the adjusted change here, since that is how consensus expectations are expressed. To approximate the annual unadjusted inflation rate for November 2012, the difference in November's headline monthly change (or forecast of same), versus the year-ago monthly change, should be added to or subtracted directly from the October 2012 annual inflation rate of 2.16%. For example, a 0.2% monthly decline in the headline November 2012 CPI-U, would tend to lower the annual inflation rate to around 1.9%

Industrial Production (October 2012). Also due for release tomorrow, Friday, December 14th, by the Federal Reserve, the headline November 2012 industrial production number is likely to show an outright decline, reflecting increasing efforts at reducing undesired business inventories, as well as some impact from the storm. While likely to disappoint minimally-positive market expectations, this series also is subject to frequent and significant downside revisions.

Weakening production already was in play before Hurricane Sandy, and the storm certainly had some residual negative impact in November. The reporting here, as with the guesstimated activity in retail sales, may be particularly skewed or volatile depending on how the Fed has adjusted the numbers for the storm. Despite what appear to be positive market expectations, for the headline number, a contraction is likely. Also a fair bet is that any "unexpected" weakness will be attributed to Sandy, not to the renewed decline in broad economic activity that was underway before the storm. Of particular interest will be the revisions to earlier, pre-storm reporting.

