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

COMMENTARY NUMBER 490
November Durable Goods, Housing Starts, GDP Revision

December 21, 2012

GDP Upside Revision Was In Health Care (and Bad Deflation of Same)

**GDI (GDP Equivalent) Annualized Third-Quarter Gain of 1.36%,
Followed Annualized Second-Quarter Contraction of 0.72%**

**Weaker November Housing Starts Reflected Mixed Storm Effects,
But Sharp Downside Revisions Were Pre-Hurricane**

Fed's Inflation Target Is Just In-House Wishful Guessing

Despite Boost from Hurricane, Durable Goods Orders Remained in Recession

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PLEASE NOTE: The next regular Commentary *is scheduled for Thursday, December 27th, covering November new home sales and providing some comments on economic and systemic developments in 2012 and an outlook into early-2013.*

Merry Christmas and best wishes to all for a joyous holiday season! — John Williams

Opening Comments and Executive Summary. The broad economic picture has not been affected by recent reporting. Given an extraordinarily-light economic calendar, next week, the December 27th regular *Commentary* will review key developments in 2013 and preview some likely near-term activity in early 2013.

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New orders for durable goods continue to look like a developing recession. Despite storm-related automobile orders, and a concurrent-seasonal-adjustment-factor system run amok, the 0.7% monthly gain in November 2012, and the 1.1% upside revision to October new orders, were within the normal range of volatility for the series. Net of inflation, new orders continued in their broad downtrend, with the latest activity remaining well below the highs seen before both the formal 2007 and 2001 recessions.

While headline growth in third-quarter gross domestic product (GDP) revised to 3.1% from 2.7%, following a 1.3% gain in the second-quarter, the GDP's bookkeeping equal of gross domestic income (GDI) continued to stagnate, revising lower to 1.4% from 1.7%, following a 0.7% contraction in the second-quarter.

The net 0.4-percentage point upside second-revision to the annualized third-quarter 2012 GDP growth rate was just fluff and statistically insignificant. The unusually large revision for a third estimate of quarterly GDP was dominated by areas such as healthcare services, for which the Bureau of Economic Analysis (BEA) has no reliable measure other than its educated guesstimation.

The 3.0% month-to-month decline in November housing was in the context of prior-period downside revisions and reflected mixed impact from Hurricane Sandy. Activity likely slowed in the storm-ravaged region, but rebuilding already has started (as seen in increasing building permits). Net-positive impact on housing starts from rebuilding is likely in the next quarter or two.

Consistent with the usual GDP nonsense, however, where housing starts revised lower in third-quarter reporting, the subsequent third-quarter GDP report revised residential investment to the upside.

The 5.9% monthly gain in November existing home sales was not meaningful, as usual, and is discussed in the *Reporting Detail* section.

Fed's Inflation Target Simply Is the Fed's Wishful Thinking for Future Inflation. In his press conference following the December 12th FOMC announcement of QE3 expansion into monetizing U.S. Treasuries, Fed Chairman Ben Bernanke hemmed and hawed about what the Federal Reserve really considered as an inflation target. It is not the latest year-to-year inflation in the PCE-deflator. Instead, it is Fed's best guess of what the "core" PCE-deflator annual inflation (net of food and energy prices) will be in a year or so, versus a maximum acceptable level of 2.5%. Where Mr. Bernanke admitted at the same press conference that the Fed is not very good at forecasting more than a quarter or so into the future, that guesstimated future inflation number can be anything the Fed wants it to be, at any given time. Otherwise, the November 2012 PCE-deflator generally moved in tandem with other official consumer inflation measures for November, with the details covered in the *Reporting Detail* section.

Third-Quarter 2012 GDP (Third Estimate). Beware growth dominated by the services sector, whether it is in net exports or consumer health care! Some sectors of economic activity can be estimated with a fair degree of meaning, such as in production areas, while estimates of activity in service areas generally are more nebulous—largely guessed at—such as with health-care services.

In the third estimate (second revision) of third-quarter GDP, consumer health-care consumption revised from an annualized contraction of 1.5% to an annualized gain of 2.6%, an upside swing of 4.1% in revision. For the full GDP, the headline 0.44-percentage point upside revision in annualized quarterly real growth (from 2.67% to 3.11%) was more than accounted for by that upside revision to consumer health care services. The healthcare revision contributed 0.48-percentage point of the aggregate upside revision,

and that gain likely had more to do with the underestimation of recent health-services inflation than anything else.

The U.S. government has a problem estimating healthcare costs at anything close to the high costs apparent in the common experience of the real world. As always, understated inflation measurement for the GDP, and the commensurate series deflation, remains a primary factor behind the regular overstatement of real (inflation-adjusted) GDP growth.

By the numbers, third-quarter headline (inflation-adjusted, annualized) GDP growth now stands at a statistically-insignificant 3.11%, versus 1.25% in the second-quarter. Year-to-year growth was 2.60% in the third-quarter versus 2.14% in the second-quarter.

The broader gross national product (GNP) number, which includes the trade balance in factor income (dividend and interest payments) showed revised headline third-quarter 2012 growth of 2.97% versus 2.05% in the second-quarter.

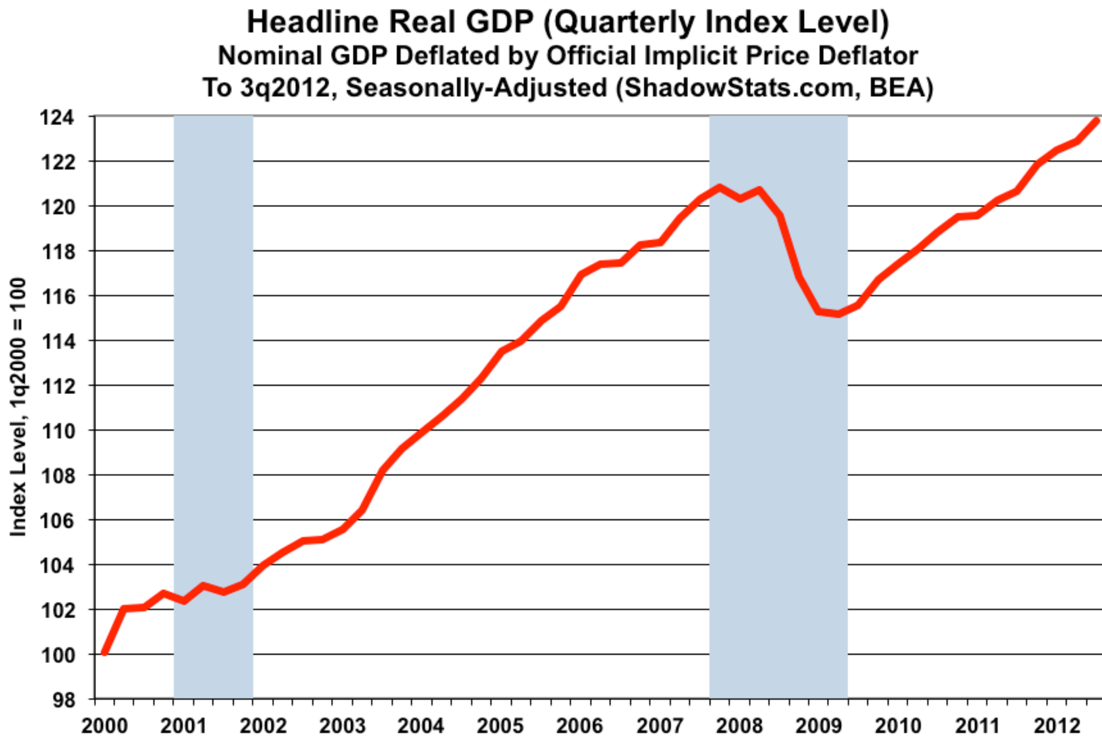
The income-side equivalent to the consumption-side GDP, GDI showed revised headline third-quarter 2012 growth of 1.36% versus a contraction of 0.72% in the second-quarter.

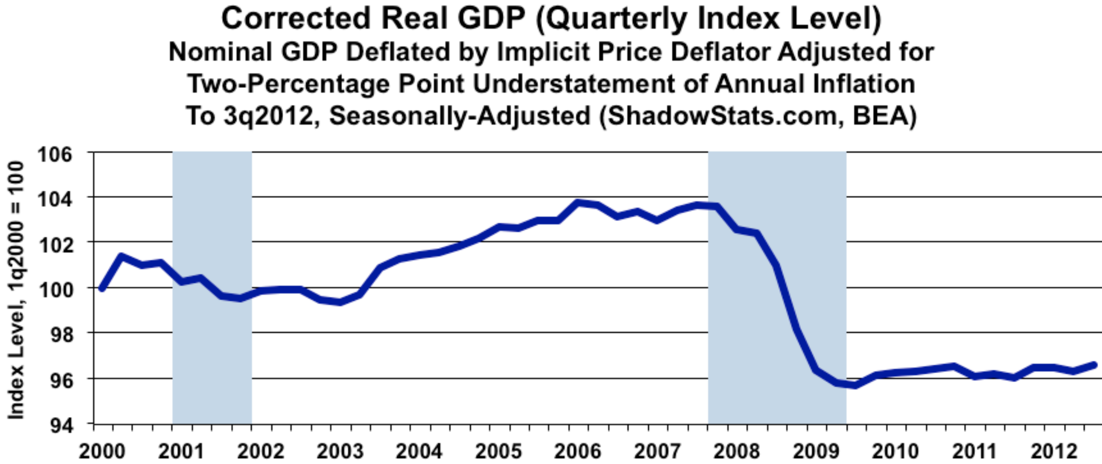
Further detail from the latest reporting is found in the *Reporting Detail* section.

Corrected Gross Domestic Product. As discussed in previous *Commentaries*, the full economic recovery indicated by the official real GDP numbers remains an illusion. It is a statistical illusion created by using too-low a rate of inflation in deflating (removing inflation effects) from the GDP series. The following two graphs tell that story. They are the same graphs on pages 10 and 11 (*Graphs 1* and *2*) of *No. 485: Special Commentary*, updated for the third estimate, second revision of third-quarter 2012 GDP.

Shown in the first graph, the official level of real GDP activity has been reported at above pre-2007 recession levels—in full recovery—since fourth-quarter 2011. No other major economic series has shown a parallel pattern of full economic recovery. Either the GDP reporting is wrong, or all other major economic series are wrong. While the GDP is heavily modeled, imputed, theorized and gimmicked, it also encompasses reporting from those various major economic series and private surveys, which attempt to survey real-world activity. Flaws in the GDP inflation methodologies have created the "recovery."

The second graph shows the GDP corrected for the understatement inherent in official inflation estimates. It plots the GDP with the deflation by the implicit price deflator (IPD) corrected for understatement of roughly two-percentage points of annual inflation in the IPD. The inflation understatement has resulted from hedonic-quality adjustments, as discussed in *Hyperinflation 2012*, *No. 485: Special Commentary* and *Public Comment on Inflation*. Both graphs are indexed to first-quarter 2000 = 100, with the plots to consistent scales.





November Durable Goods Orders Remained Within Normal Reporting Ranges. Despite some likely pick-up in automobile orders tied to replacement of storm-damaged vehicles, the November 2012 monthly gain of 0.7%, and an upside revision to October's reporting that resulted from concurrent-seasonal-factor issues, both were within the range of normal volatility for the series. As reflected in the inflation-adjusted graphs, the durable goods series looks like it already is in a renewed economic downturn.

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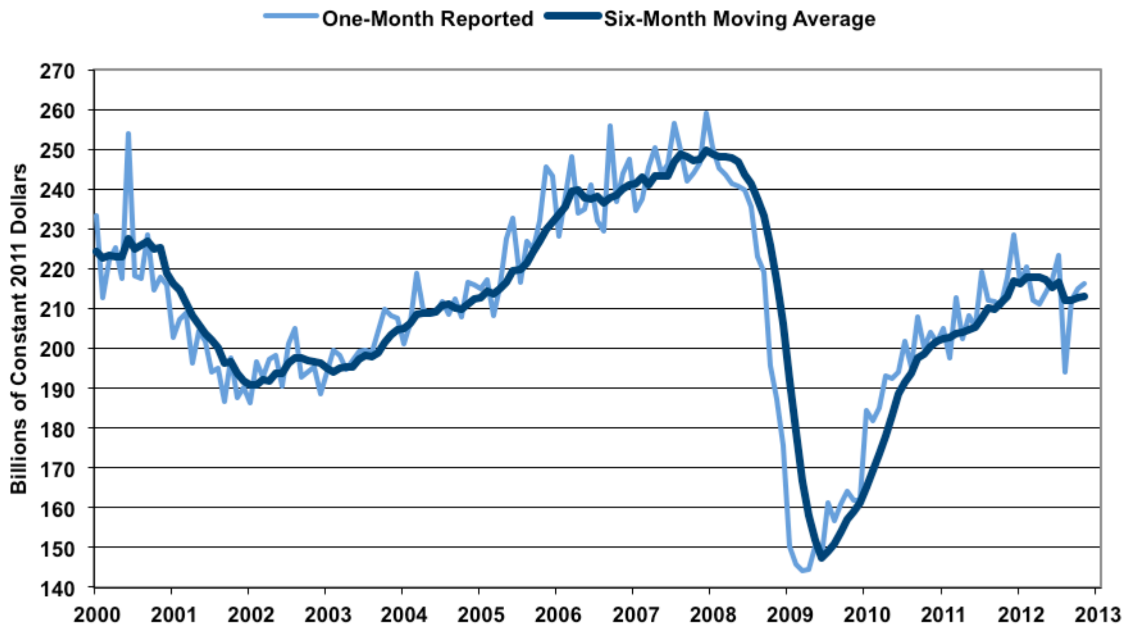

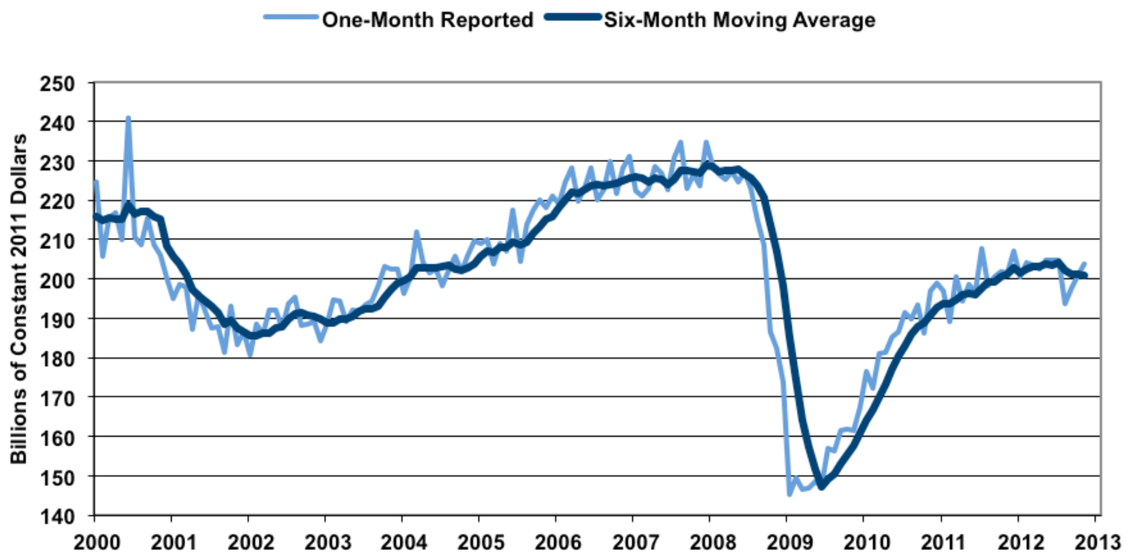

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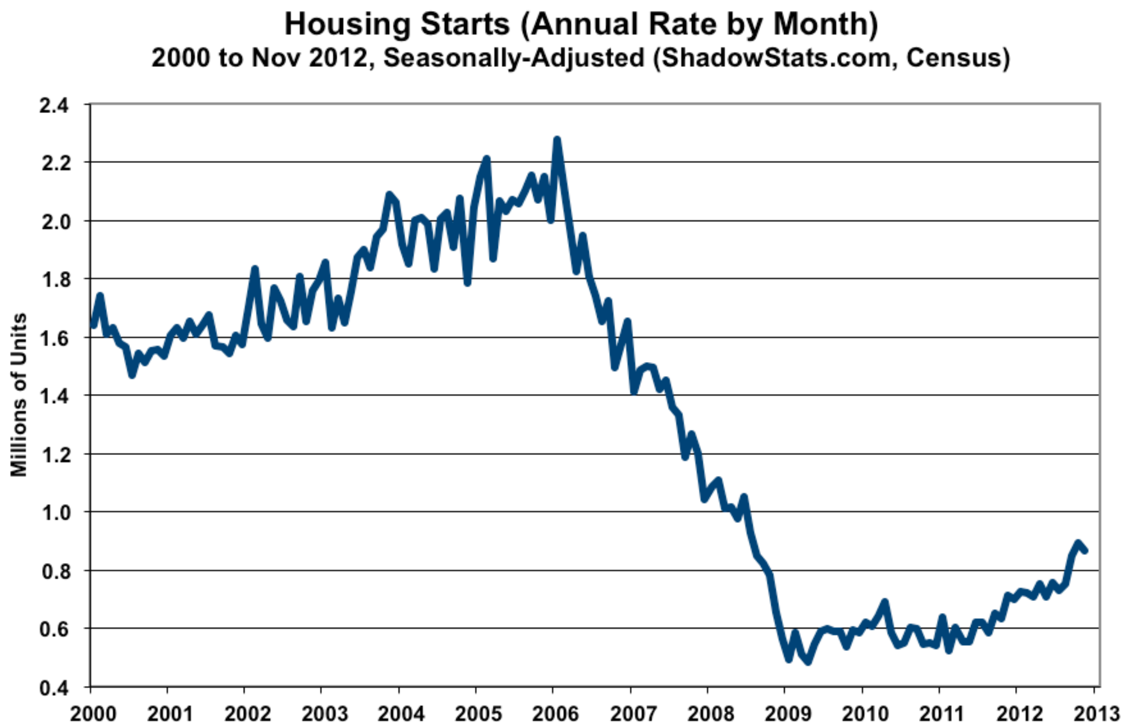
As shown and discussed in prior *Commentaries*, the preceding two graphs plot new orders for durable goods, adjusted for inflation (using the PPI finished goods capital equipment index) and smoothed. These graphs plot the monthly as well as a six-month moving average of activity levels. The first graph shows the aggregate new orders series; the second series is net of the extremely volatile commercial-aircraft order sector. The first graph also is an updated version of *Graph 10*, on page 16 of *No. 485: Special Commentary*, reflecting the November estimate of new orders as well as prior-period revisions that just were published.

In terms of inflation-adjusted level, these series have shown a slowing uptrend and flattening-out in the last two-to-three years—now in a pattern of downturn—clearly not the recovery that is seen in official GDP reporting. The real (inflation-adjusted) level of orders in November and October 2012 remained below both the pre-2001 and pre-2007 recession highs.

The pattern of decline unfolding in new orders is one that usually precedes or is coincident with a recession, as suggested in these historical graphs of the inflation-adjusted series, both aggregate and net of nondefense aircraft.

If the deflation measure here were corrected meaningfully for hedonic-adjusted understatement of inflation, the post-2009 uptrend in real orders likely would be little more than a flat line, reflecting ongoing bottom-bouncing along a low-level plateau of economic activity, with the most recent reporting turning increasingly negative.

Housing Starts Still in Protracted Period of Stagnation, Despite Occasional Bounces. Seen in the next two graphs, the housing industry remains terribly impacted by consumer and bank liquidity problems.



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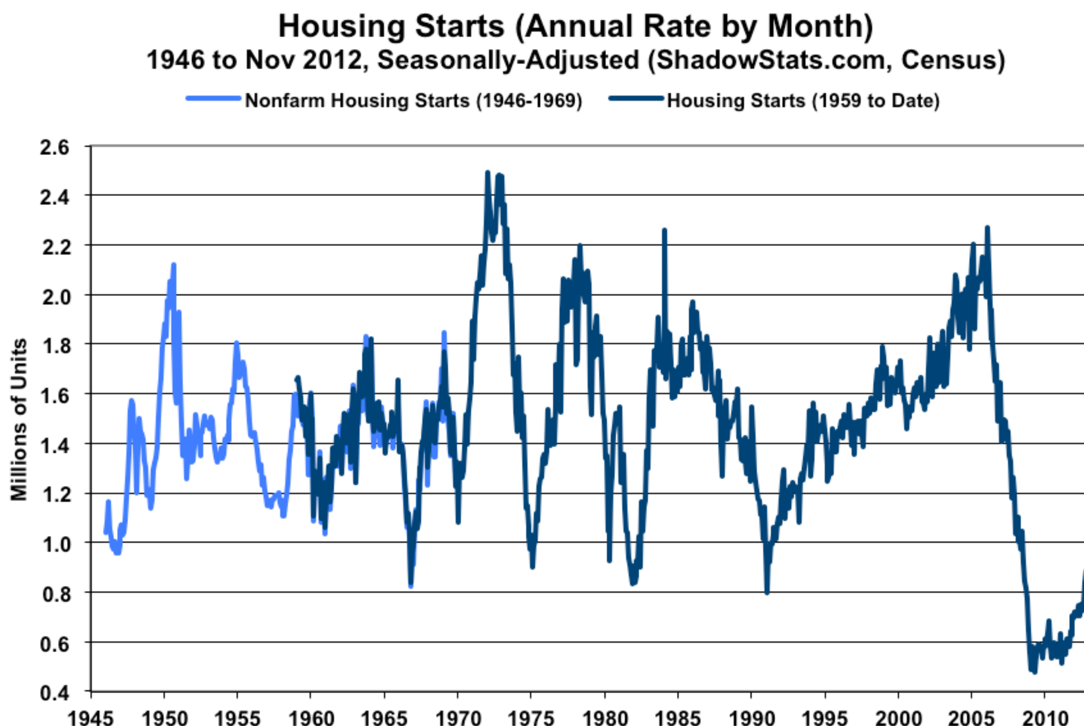

With minimal levels of consumer confidence and sentiment, and without positive real (inflation-adjusted) income growth and available credit, consumers generally cannot support real growth in broad consumption, let alone fuel a renewed housing boom. The financially-impaired banking system still largely is sitting on the sidelines, despite four-plus years of systemic-liquefaction efforts by the Federal Reserve.

Nonetheless, insurance payments on hurricane-damaged properties should help provide at least some temporary boost to the home construction industry in the next quarter or so.

November housing starts fell month-to-month by a statistically-insignificant 3.0%, likely reflecting mixed pressures from storm disruptions and rebuilding. The November loss, however, was in the context of downside revisions to reported activity of the last several months, in this highly volatile series.

[More complete details on housing, durable goods and the revised GDP are found in the* Reporting Detail *section.]

HYPERINFLATION WATCH

Special Commentary (No. 485), published on November 27th, updated *Hyperinflation 2012* and the broad outlooks for the economy and inflation, as well as for systemic stability and the U.S. dollar. No subsequent economic releases and no subsequent advertised negotiating activity by Washington politicians on the "fiscal cliff" and debt-ceiling expansion have altered those outlooks. The expansion of

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QE3 by the Fed, on December 12th, however, continued the regular unfolding of events that eventually will trigger a hyperinflation, as discussed in *Commentary No. 488*.

The Fed's activity can be viewed as a signal of deepening problems in the banking system. As discussed by Mr. Bernanke, the Fed can do little to stimulate the economy, but it can create inflation. Nonetheless, the Fed's move here was to prop-up the banking system and to provide back-up liquidity to the U.S. Treasury in the months ahead. Direct monetization of Treasury debt 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. Those issues, however, could be exacerbated rapidly by significant problems out of what appears to be, at least temporarily, deteriorating government negotiations aimed at handling the "fiscal cliff" and debt ceiling (see *Commentary No. 488* for further detail).

For new subscribers, as well as for those who otherwise are not familiar with the hyperinflation report or the recent 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

NEW ORDERS FOR DURABLE GOODS (November 2012)

November Durable Goods Orders Possibly Boosted by Replacement Needs for Hurricane-Damaged Automobiles. The 0.7% monthly gain reported for November 2012 new orders for durable goods might have reflected some damaged-automobile-replacement impact from Hurricane Sandy. Yet, the upside revision to October's orders—from being unchanged to a gain of 1.1%—appears to have been largely from the concurrent-seasonal-factor process running amok, as opposed to a sudden surge of previously unreported orders. Unadjusted, October orders revised higher by 0.6%, the balance of the seasonally-adjusted revisions was in the month-to-month shifting of unstable concurrent-seasonal-factor adjustments.

Nonetheless, the monthly order volatility was within the usual scope of the series, and the broad pattern of downturn continues and is of a nature that usually precedes or coincides with a recession (contracting broad general economic activity), as suggested in the historical graphs of the real (inflation-adjusted) series, both aggregate and net of nondefense aircraft, in the *Opening Comments and Executive Summary* section. The level of November 2012 real new orders remained below both the pre-2001 and pre-2007 recession highs for the series.

Note on Deflating New Orders for Durable Goods: As described in Special Commentary No. 426*, there is no fully appropriate inflation measure available for deflating durable goods. The one used in the "real" graphs is the PPI's inflation measure for finished goods capital equipment (PPI-FGCE), an official inflation measure. The problem with that measure is in the hedonic quality adjustments to prices, where nebulous "quality improvements," which cannot be measured directly and are not consistently applied to all products, are modeled in incredibly imprecise efforts by the government to reduce reported inflation versus real-world experience. The same issues are part of the methodological problems that significantly understate the CPI and the GDP implicit price deflator inflation measures.*

In terms of smoothing, the graphs in the Opening Comments and Executive Summary *section reflect a six-month moving average, as well as the raw monthly data. The detail also is graphed net of nondefense aircraft orders, a significant cause of month-to-month volatility in the series.*

Official, Nominal November Reporting. The Census Bureau reported this morning, December 21st, that the regularly-volatile, seasonally-adjusted nominal (not adjusted for inflation) level of November 2012 new orders for durable goods rose by 0.7% (up by 1.8% before prior-period revisions) month-to-month, following a revised 1.1% gain (previously unchanged) in October.

The irregular and highly volatile long-term nondefense aircraft orders dropped by 13.9% (down by 8.7% before prior-period revisions) month-to-month in November, following a revised 0.2% gain (previously a 5.8% decline) in October, yet those changes reflected severe concurrent-seasonal-adjustment instabilities. Aircraft orders usually are placed years in advance of delivery and rarely impact near-term economic activity. Net of the distorted and unstable commercial aircraft orders, aggregate new orders rose by 1.8% in the month, following 1.2% gain in October.

Unadjusted, year-to-year change in total November 2012 new orders increased by 0.5%, down from a revised 5.9% (previously 5.4%) gain in October.

Also heavily affected by volatility in nondefense aircraft orders, seasonally-adjusted new orders for nondefense capital goods fell by 2.8% for the month of November, following a revised 2.8% (previously 0.8%) gain in October. For November 2012, the unadjusted year-to-year decline in the series plunged by a 9.0%, following a revised 4.3% (previously 3.8%) annual gain.

Caution: Current durable goods reporting remains subject to many of the same sampling and concurrent-seasonal-adjustment problems that are seen with retail sales and payroll reporting. Unusual seasonal-factor volatility raises issues as to the significance of reported seasonally-adjusted monthly changes.

Inflation-Adjusted and Smoothed. The nominal 0.7% gain in aggregate November orders was a real (inflation-adjusted) gain of 0.6%, after adjusting for a small monthly gain in the PPI finished goods capital equipment deflator. The revised nominal 1.1% gain in October translated to an inflation-adjusted 1.4% gain, after a monthly decline in the respective October PPI deflator.

In terms of inflation-adjusted level, however, as indicated in the graphs in the *Opening Comments and Executive Summary* section, both the aggregate new orders and aggregate orders net of commercial aircraft series, have shown a slowing uptrend and flattening-out in the last two-to-three years—now in a pattern of downturn—clearly not the recovery that is seen in official GDP reporting. The real (inflation-adjusted) level of orders in November and October 2012 remained below both the pre-2001 and pre-2007 recession highs.

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If the deflation measure here were corrected meaningfully for its hedonic-adjusted understatement, the post-2009 uptrend in seen in the graphs of real orders likely would be little more than a flat line, reflecting ongoing bottom-bouncing along a low-level plateau of economic activity, with the recent pattern of downturn now well entrenched.

GROSS DOMESTIC PRODUCT—GDP (Third-Quarter 2012, Third Estimate, Second Revision)

Still Little More than Statistical Noise, Third-Quarter GDP Headline Growth Revision to 3.11% from 2.67%, Reflected a Poorly Deflated, Sudden in Surge Health Care Consumption. The third estimate, second revision of third-quarter 2012 GDP was just as meaningless as prior estimates in terms of having any relationship to underlying real-world economic activity. The headline growth rate remained within the 95% reporting confidence interval of +/- 3.5%. This most-worthless and most-heavily-politicized of government economic series still does not reflect properly or accurately the changes to the underlying fundamentals that drive the series. A discussed in the *Opening Comments*, a poorly-deflated upside revision to consumer health care services more than accounted for the scope of entire upside second revision.

As discussed in *No. 485: Special Commentary* and in the *Opening Comments*, the GDP remains the only major economic series to show a full economic recovery, since onset of official recession in December 2007. Either the GDP numbers are wrong, or all the other major economic releases are wrong. As discussed again, and graphed in the *Opening Comments*, the real GDP's upswing in activity since mid-2009 has been no more than a statistical illusion resulting from the use of bad-quality inflation data.

Notes on GDP-Related Nomenclature and Definitions

For purposes of clarity and the use of simplified language in the text of the GDP analysis, here are definitions of several key terms used related to GDP reporting:

***Gross Domestic Product (GDP)** is the headline number and the most widely followed broad measure of U.S. economic activity. It is published quarterly by the Bureau of Economic Analysis (BEA), with two successive monthly revisions, and with an annual revision in the following July.*

***Gross Domestic Income (GDI)** is the theoretical equivalent to the GDP, but it generally is not followed by the popular press. Where GDP reflects the consumption side of the economy and GDI reflects the offsetting income side. When the series estimates do not equal each other, which almost always is the case, since the series are surveyed separately, the difference is added to or subtracted from the GDI as a "statistical discrepancy." Although the BEA touts the GDP as the more accurate measure, the GDI is relatively free of the monthly political targeting the GDP goes through.*

***Gross National Product (GNP)** is the broadest measure of the U.S. economy published by the BEA. Once the headline number, now it rarely is followed by the popular media. GDP is the GNP net of trade in factor income (interest and dividend payments). GNP growth usually is weaker than GDP growth for net-debtor nations. Games played with money flows between the United States and the rest of the world tend to mute that impact on the reporting of U.S. GDP growth.*

***Real** (or **Constant Dollars**) means the data have been adjusted, or deflated, to reflect the effects of inflation.*

***Nominal** (or **Current Dollars**) means growth or level has not been adjusted for inflation. This is the way a business normally records revenues or an individual views day-to-day income and expenses.*

***GDP Implicit Price Deflator (IPD)** is the inflation measure used to convert GDP data from nominal to real. The adjusted numbers are based on "Chained 2005 Dollars," at present, where the 2005 is the base year for inflation, and "chained" refers to the methodology which gimmicks the reported numbers so much that the total of the deflated GDP sub-series misses the total of the deflated total GDP series by nearly $107 billion in "residual" as of fourth-quarter 2011.*

***Quarterly** growth, unless otherwise stated, is in terms of seasonally-adjusted, annualized quarter-to-quarter growth, i.e., the growth rate of one quarter over the prior quarter, raised to the fourth power, a compounded annual rate of growth. While some might annualize a quarterly growth rate by multiplying it by four, the BEA uses the compounding method, raising the quarterly growth rate to the fourth power. So a one percent quarterly growth rate annualizes to 1.01 x 1.01 x 1.01 x 1.01 = 1.0406 or 4.1%, instead of 4 x 1% = 4%.*

***Annual** growth refers to the year-to-year change of the referenced period versus the same period the year before.*

GDP. Published December 20th by the Bureau of Economic (BEA), the third estimate (second revision) of third-quarter 2012 gross domestic product (GDP) showed revised real (inflation-adjusted) annualized quarterly growth at a statistically-insignificant 3.11% +/- 3.5% (95% confidence interval), up from the revised prior headline number of 2.67%, and from initial reporting of 2.01%. The latest headline growth estimate was against a 1.25% headline gain in the second-quarter, and versus 1.96% growth reported in the first-quarter.

For six of the seven quarters since first-quarter 2011 (fourth-quarter 2011 excepted), estimated growth rates have been little more than statistical noise around the unchanged level, and these heavily guessed-at numbers possibly have been massaged to keep the quarterly growth rates in minimally-positive, as opposed to minimally-negative territory. The latest third-quarter revision was revised higher based largely on growth in "services"—heavily modeled and guessed at—where the 0.44-percentage point upside revision to third-quarter growth was more than accounted for by a 0.48-percentage revised upside contribution to the GDP growth rate from health-care services.

Reflected in the following graph, the revised estimate of year-to-year real change in third-quarter 2012 GDP was 2.60%, up from prior reporting of 2.49%, and from initial reporting of 2.32%, versus 2.14% headline growth in second-quarter 2012, and 2.45% in first-quarter 2012. The latest annual growth remains off the near-term peak growth of 2.80% reported during third-quarter 2010. The current cycle trough was in second-quarter 2009 at a 4.58% year-to-year decline, the deepest annual contraction seen for any quarterly GDP in the history of the series, which began with first-quarter 1947.

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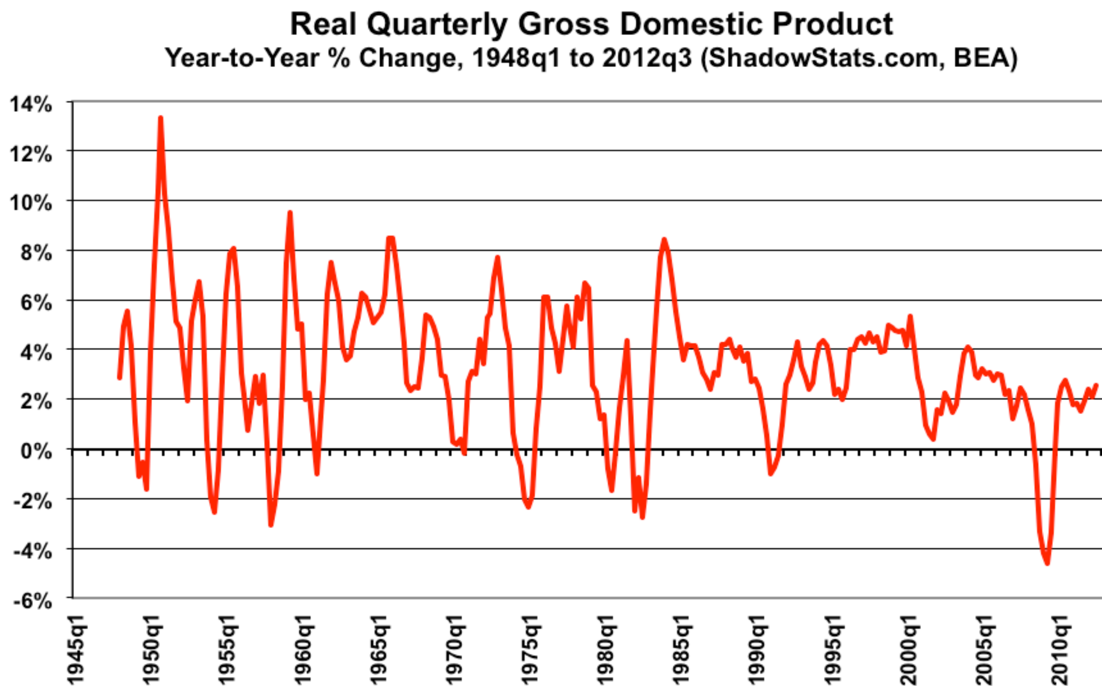


Implicit Price Deflator (IPD) and PCE Deflator. The third-quarter 2012 GDP implicit price deflator (IPD) revised to an annualized quarterly inflation rate of 2.72%, versus previous reporting of 2.80%, and initial reporting of 2.90%. The downside revision to GDP inflation rate was responsible for 0.08-percentage point of the 0.44-percentage point aggregate upside revision to the headline growth rate. The annualized IPD inflation was 1.53% in the second-quarter, and 2.17% in the first-quarter. Third-quarter year-to-year IPD inflation was estimated at a revised 1.63%, versus the previous 1.65%, and the initial 1.68%, down from 1.70% in the second-quarter, and down from 1.98% in the first-quarter. The unrevised annual inflation estimate for the third-quarter PCE-deflator is discussed in the *PCE-Deflator* section.

For comparison purposes, annualized seasonally-adjusted quarterly inflation for the CPI-U in third-quarter 2012 was 2.30%, versus 0.75% in the second-quarter and 2.48% in the first-quarter, with year-to-year CPI-U at 1.70%, versus 1.89% in the second-quarter and 2.82% in the first-quarter.

The lower the inflation rate that is used in deflating the GDP, the stronger will be the resulting inflation-adjusted number and vice versa.

SGS-Alternate GDP. The SGS-Alternate GDP estimate for third-quarter 2012 remains at a 2.1% year-to-year contraction versus the revised official estimate of a 2.6% gain. The SGS third-quarter estimate is a narrower contraction than the 2.2% estimated for second-quarter 2012, versus the official estimate of 2.2% year-to-year growth (see the Alternate Data tab).

While annualized real quarterly growth is not estimated formally on an alternate basis, a quarter-to-quarter contraction once again appears to have been a realistic possibility for the third-quarter, as it has been for six of the last seven quarters, a period of protracted business bottom-bouncing in the real world.

Adjusted for gimmicked inflation and other methodological changes, the business downturn that began in 2006/2007 is ongoing; there has been no meaningful economic rebound. The corrected real GDP graph (see the *Opening Comments and Executive Summary* section and *Hyperinflation 2012* and *No. 485: Special Commentary*) is based on the removal of the impact of hedonic quality adjustments that have reduced the reporting of official annual GDP inflation by roughly two-percentage points. It is not the same measure as the SGS-Alternate GDP, which reflects the impact of reversing additional methodological distortions of recent decades.

GDI. Gross domestic income (GDI) is the income-side reporting equivalent of the consumption-side GDP. Free of most of the media hype that helps to shape the GDP reporting, the GDI can be more meaningful in its separate surveying and lack of relative political massaging. Where the GDI and GDP have to equal each other from a bookkeeping standpoint, that rarely happens. The difference is made up by the use of a statistical-discrepancy account that is included on the GDI side to establish GDP-GDI parity. In the first-revision here to annualized, real third-quarter GDI growth, the headline growth rate weakened to 1.36%, from an initial estimate of 1.68%, versus a 0.72% annualized contraction in the second-quarter. Year-to-year third-quarter 2012 GDI growth eased to 2.1%, in revision, versus an initial estimate of 2.29%, versus 1.80% in the second-quarter.

GNP. Gross national product (GNP) is the broadest measure of U.S. economic activity, where GDP is GNP net of trade in factor-income, or interest and dividend payments. In initial reporting, the headline third-quarter 2012 GNP growth rate was a revised 2.97%, versus initial reporting of 2.67%, and versus 2.05% in the second-quarter. Year-to-year GNP was revised to 2.42%, versus an initial 2.36% in the third-quarter, and versus 2.06% in the second-quarter.

PERSONAL CONSUMPTION EXPENDITURE (PCE) DEFLATOR (November 2012)

Fed's Inflation Target Is Nonsense. In his press conference following December 12th FOMC announcement that QE3 would be expanded to monetize U.S. Treasuries, Fed Chairman Ben Bernanke hemmed and hawed about what the nature of the Federal Reserve's inflation. It is not the latest reporting of year-to-year inflation in the PCE-deflator, as otherwise detailed in this section. Instead it is that Fed's guess of what the "core" annual PCE-deflator inflation rate (net of food and energy prices) will be in a year or so, with an upside allowable maximum forecast of 2.5%. With Mr. Bernanke having admitted at the same press conference that the Fed is not very good at forecasting more than a quarter or so into the future, that guesstimated inflation number can be anything the Fed wants it to be, at any given time.

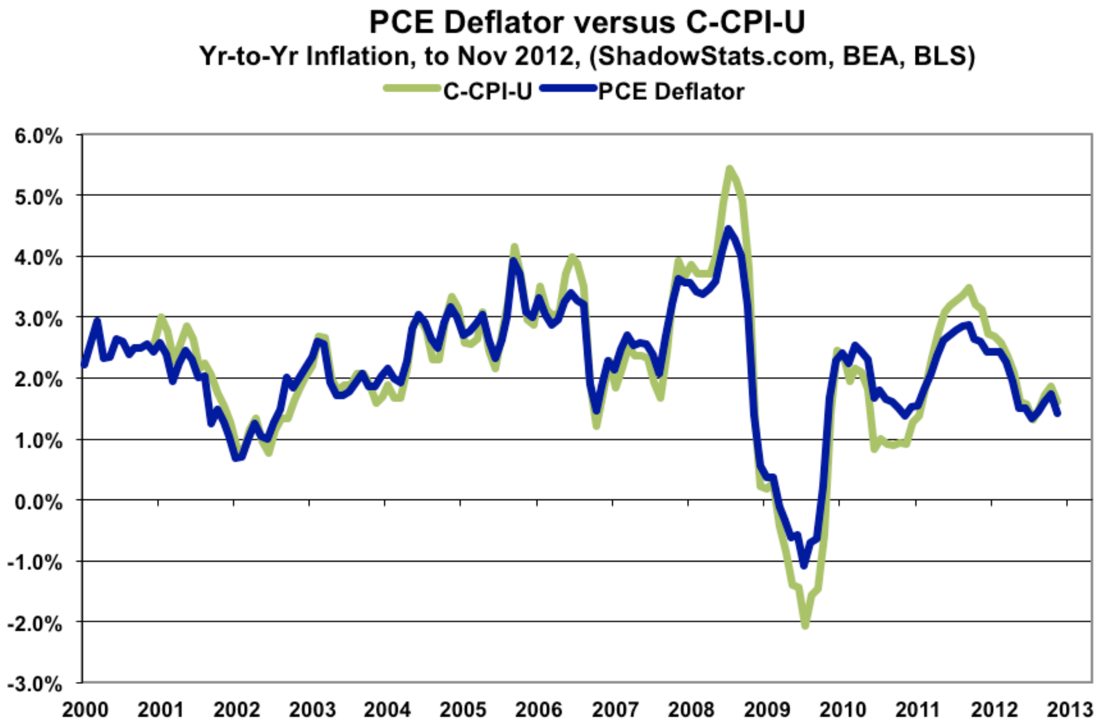
Once again, this "inflation targeting" effort by the Federal Reserve remains window-dressing for those in the markets who think the Fed really would move to contain inflation at the cost of impairing still-fragile banking-system solvency. The Fed's primary function remains keeping the banking system afloat, at any cost, as suggested anew by the introduction and expansion of QE3, and as likely will be demonstrated again as the U.S. central bank reacts with increasing vigor to a re-intensifying systemic-solvency crisis.

The PCE deflator otherwise is meaningless as an inflation indicator. If subscribers following the PCE deflator would like this section continued, I am most happy to do so. Please just send me an e-mail at johnwilliams@shadowstats.com with the heading "Continue PCE deflator."

November PCE-Deflator Softened in Tandem With Other Consumer Inflation Measures. Released this morning, December 21st, by the Bureau of Economic Analysis (BEA), the regularly-unstable implicit pricing residual for personal consumption expenditure—published as the seasonally-adjusted November PCE deflator—was down for the month by 0.22% (down by 0.27% before prior-period revisions), versus a revised 0.12% (previously 0.13%) monthly gain in October.

Year-to-year, the PCE-deflator weakened to 1.42% in November 2012, versus a revised 1.72% (previously 1.74%) annual inflation rate in October 2012. Annual PCE inflation held below the Fed's previously-purported 2.0% inflation target for the seventh straight month.

PCE Deflator versus Other Inflation Measures. Where, in theory, the PCE deflator measure should be virtually identical to the fully substitution-based chain-weighted-CPI (C-CPI-U) (see *Commentary No. 489* for details of the latest C-CPI-U and other inflation measures), and it actually moved at the levels seen in the C-CPI-U in the three months through September 2012. Annual inflation reported in the October and November C-CPI-U, however, pulled ahead of the PCE-deflator, once again.



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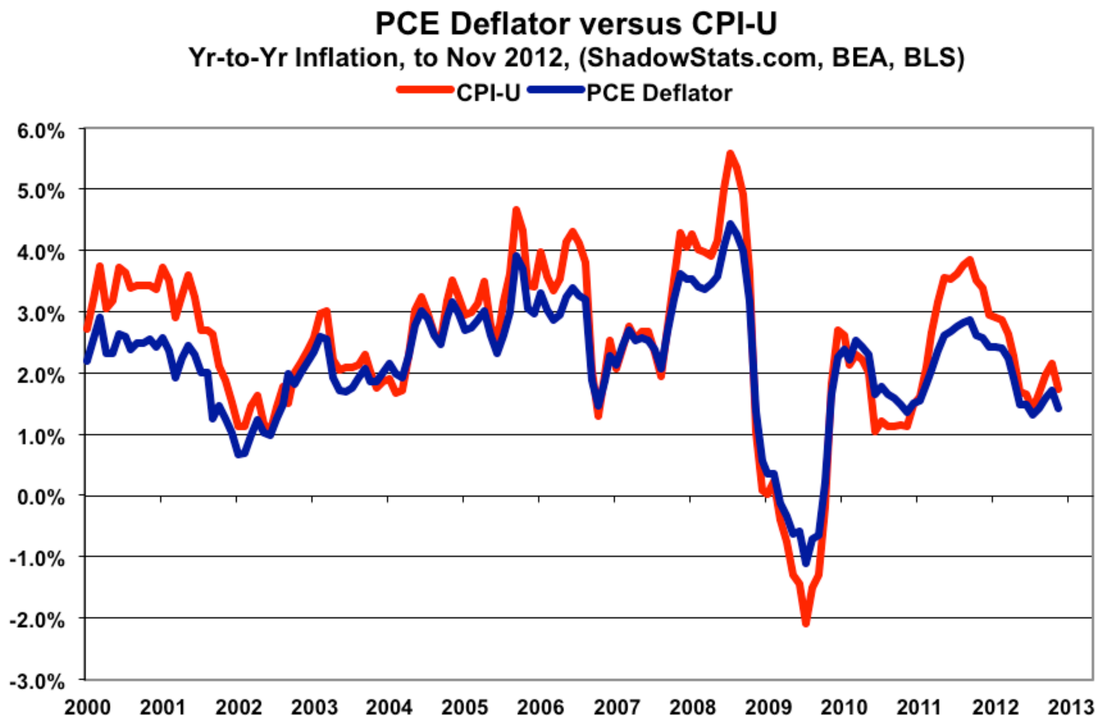

In contrast, despite all the methodological manipulation aimed at making the CPI-U a fully-substitution-based index, that process is not complete, and headline CPI-U annual inflation generally remained stronger than the PCE-deflator and C-CPI-U measures in November, as it did in October. Those series are shown in the accompanying graphs; see the *Public Comment on Inflation* for further detail on the methodological machinations.

The November 2012 PCE deflator showed 1.4% year-to-year inflation, versus a 1.7% in October. That compared with annual inflation in the November C-CPI-U at 1.6%, versus 1.9% in October; November CPI-U at 1.8%, versus 2.2% in October; November CPI-W at 1.7%, versus 2.2% in October; and the November SGS-Alternate (1980-Base) at 9.4%, versus 9.8% in October.

Revised Third-Quarter PCE Deflator. As part of the second revision to third-quarter GDP, year-to-year change in the third-quarter personal consumption expenditures (PCE) deflator was not revised and held at 1.45%, against initial reporting of 1.50% in the first-quarter, against 1.64% in the second-quarter, and 2.36% in the first-quarter. For comparison purposes, year-to-year CPI-U inflation was 1.70% in third-quarter 2012, versus 1.89% in the second-quarter, and 2.82% in the first-quarter.

This PCE-deflator number, which had been described by the Fed as its "inflation target," otherwise is gamed by the BEA to reduce GDP inflation, artificially, with the result of overstating inflation-adjusted GDP growth. Overstated economic activity and understated inflation numbers are happy news for both the federal government and for the Federal Reserve.

NOTE: The PCE deflator is the heavily massaged and modeled inflation rate for personal consumption expenditure, published on a monthly basis by the Bureau of Economic Analysis (BEA), and quarterly as

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part of the GDP release. The monthly series, which is a surrogate measure of consumer inflation—fully substitution and hedonic-based, in addition to the political massaging—generally tends to yield the lowest annual consumer inflation rate of any major series. Unlike the more widely followed CPI-U and CPI-W measures, which never are revised, as published on a seasonally unadjusted-basis, the PCE deflator is heavily revised, forever, following initial reporting, and it is available only on a massaged, seasonally-adjusted basis.

RESIDENTIAL CONSTRUCTION (November 2012)

Prior Reporting Revised Lower, While Hurricane Sandy Had Mixed Impact on Latest Numbers. Though lower than the downwardly revised October reporting, the headline November 2012 housing starts number still was at its highest monthly level (excepting recent months) since July 2008, when the series was in free-fall. The headline number of 861,000 annualized starts (71,750 actual monthly starts) in November was down by a statistically-insignificant 3.0% for the month, versus an October number that had been revised lower by 0.7%, and a September number that had been revised lower by 2.3%.

Hurricane Sandy appears to have had minimal impact on October activity, but it seems to have had a net negative impact on November, between starts that were delayed, versus some upside offset from rebuilding activity. Likely affected in that area were November 2012 building permits, which rose by a statistically-significant 3.6% for the month, which followed a 2.5% monthly decline in October. The upside rebuilding activity should be temporary, though, stretched out in the next quarter or so.

With the downside revisions to third-quarter (September) data in the highly volatile housing-starts series, the annualized quarter-to-quarter growth for third-quarter 2012 slowed once again, to 22.5%, from the 26.6% reported last month, and from initial reporting of 30.3%, versus an unrevised annualized quarterly growth rate of 12.3% in the second-quarter. Annualized quarterly growth rates are used here, because that is the way the GDP is reported. Nonetheless, the subsequent revision to real third-quarter GDP, restated growth in residential investment to the downside, to 13.5%, from 14.2%. Such is consistent with extremely poor-quality and heavily-gimmicked reporting that defines the GDP series.

As reported, the November 2012 number was 62% below the January 2006 series high. This series remains particularly volatile and tends to suffer large monthly revisions, as well as irregular monthly distortions from a host of other factors, as discussed in *Hyperinflation 2012* and *No. 485: Special Commentary*.

Protracted stagnation in housing starts at historically-low levels of activity has continued well into its fourth year of activity, still averaging 73% below 2006's record-high construction level. Nonetheless, within the normal scope of volatility for the series in the last four years, a slightly higher plateau of activity has developed in the thirteen months, through November 2012, that is 67% below the 2006 high. Given the underlying economic fundamentals, there is no recovery or relief in sight, other than for a temporary rebuilding boost from hurricane impact.

Housing Starts November 2012 Reporting. The Census Bureau reported, December 19th, a statistically-insignificant, month-to-month headline decline in seasonally-adjusted November 2012 housing starts of 3.0% (a contraction of of 3.7% before prior-period revisions) +/-16.7% (all confidence intervals are at the

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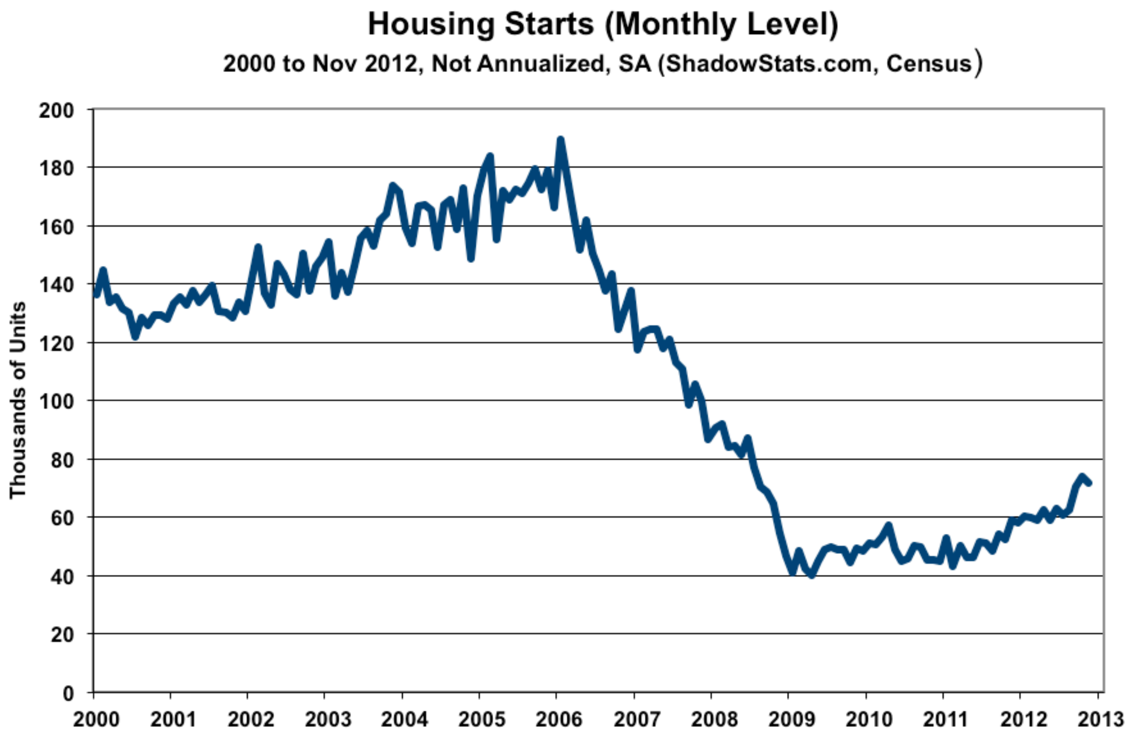
95% level). October housing starts activity revised to a 5.3% gain, from initial reporting of a 3.6%, but that was against a 2.3% downside revision to September's level.

Starts for single-unit structures in November declined by a statistically-insignificant 4.1% +/- 15.6%, for the month, following a unrevised 0.2% decline in October.

Activity in starts for apartment buildings (5 units or more) remained volatile, but, as usual, it was no more than statistical noise. Month-to-month, apartment starts rose by a statistically-insignificant 1.4% +/- 58.0% in November, versus a revised 14.7% (previously 10.0%) gain in October.

The year-to-year change in aggregate November 2012 housing starts was a statistically-significant increase of 21.6% +/- 25.3%, following a revised 40.9% (previously 41.9%) annual gain in October, but, again, that remains in the continued context of what has been a protracted period of low-level bottom-bouncing in a highly unstable series.

For the last 48 months, the pattern of housing starts generally has remained one of stagnation at an historically low-level plateau of activity. Since December 2008, housing starts have averaged a seasonally-adjusted monthly rate of 52,000. In that period, monthly readings have been within the normal range of monthly variability for the aggregate series, around that average, except for the respective October and November 2012 readings of 74,000 and 71,800, which were beyond the upper end of that range. Nonetheless, activity appears to have moved to a somewhat higher plateau since November 2011, with the average of the monthly housing starts at 63,000 for the thirteen months through November 2012.



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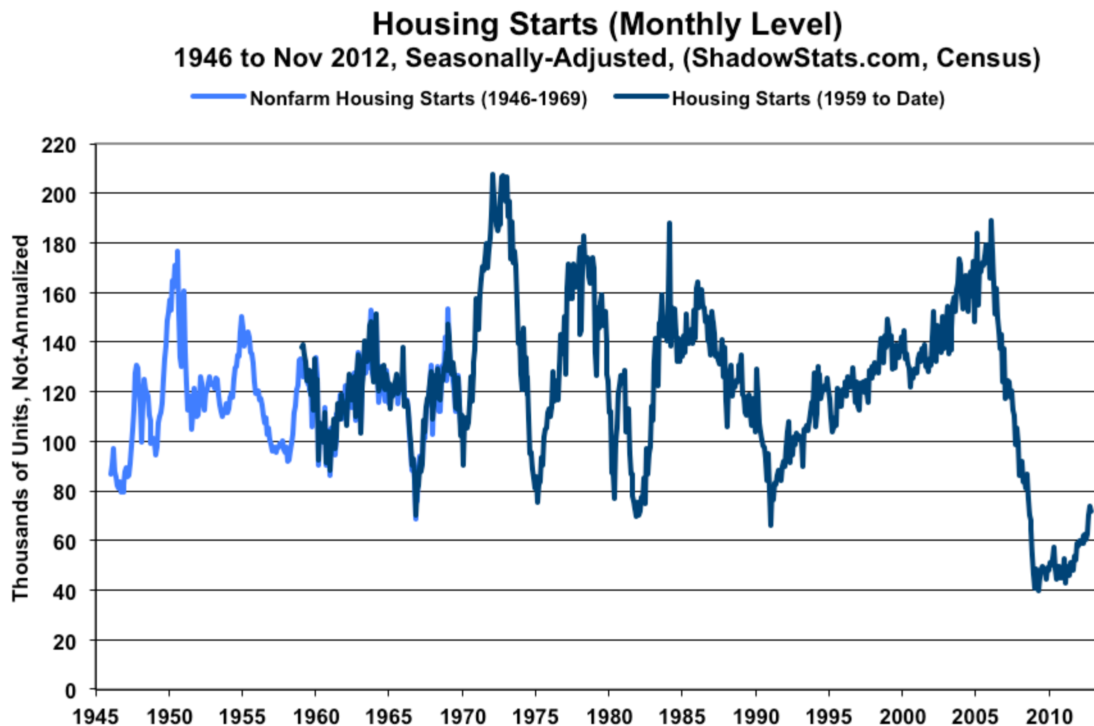

The official reporting of monthly housing starts is expressed at an annualized monthly pace, which was 861,000 for November 2012. Due to regular, extreme monthly volatility in this series, however, it is my preference to use the actual, non-annualized monthly number. The graphed patterns are the exactly same, it is just that the monthly levels tend to be a little more realistic.

The regular graphs (in annualized millions) for this series are shown in the *Opening Comments and Executive Summary* section. The same graphs in thousands of actual starts per month are the two graphs preceding. Current monthly housing starts activity is at a four-year high, well off the record monthly low seen for the present series in April 2009. Since September 2012, monthly levels of activity have notched just above the levels of activity seen at the troughs of the most severe post-World War II declines in housing starts shown in the current series, or in the predecessor nonfarm housing starts series.

EXISTING-HOME SALES (November 2012)

November Existing-Home Sales Gain of 5.9% Was Within Normal Scope of Month-to-Month Volatility for the Series. Beyond the massive downside corrections to the existing-home sales series—published one year ago with the November 2011 data—reporting for the existing-home sales series remains subject to a high level of irregular volatility and significant seasonal-factor instabilities, as also has been seen in a number of government series. Those seasonal-factor distortions are a result of the severe depth and length of the economic contraction, a circumstance that post-World War II (or modern) economic reporting never was designed to handle.

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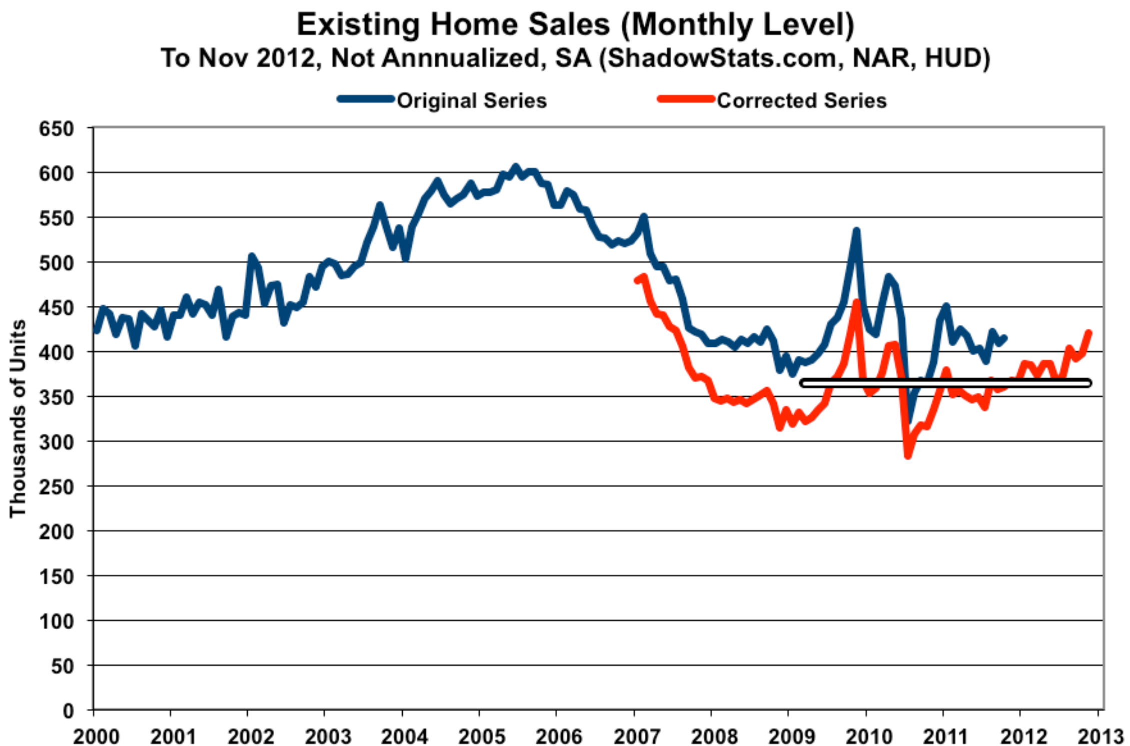
Further, as shown in the accompanying graph, the old (pre-November 2011) and corrected series do not appear to be consistent or comparable, effectively a discontinuity in the series. Seasonal-factor distortions have been skewed, not only by protracted, collapsing activity, but also by the impact of various stimulus/tax-incentive packages, which pulled some future sales activity into the periods of the incentives. With the sales swings generated by the stimulus packages, and lapsing of same, averaged out—as shown in the graph—the pattern of activity resembles the bottom-bouncing seen previously in the new-home sales, and in housing-starts activity discussed in the prior section, although the existing home sales peak-to-trough contraction never was as severe as that seen in the sales tied to new construction.



Existing Home Sales Reporting. The December 20th release of November 2012 existing-home sales (counted based on actual closings, National Association of Realtors [NAR]) showed a seasonally-adjusted monthly gain of 5.9% (up by 5.2% net of prior-period revisions), against a revised 1.5% (previously-estimated 2.1%) gain in October. While the November sales gain was well within the normal scope of month-to-month volatility for this series, the initial headline seasonally-adjusted November monthly pace of 420.0 thousand home sales was the highest level of activity since the re-defined November 2009 number. November 2012 activity may have reflected some closings being shifted from October, as well as some possible other distortions from Hurricane Sandy. That said, given the previously-discussed instabilities in seasonal factors and in underlying reporting, there is little significance, if any, that can be attributed to the headline monthly number for November, at this time.

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On a year-to-year basis, November sales rose by 14.5%, versus a revised October annual sales gain of 10.2% (previously 10.9%). Recent volatility in annual change still partially reflects the effects of lapsing housing stimulus efforts the year before. Smoothed for irregular distortions, the series remains statistically consistent with an ongoing pattern of broad stagnation.

The portion of distressed properties in existing sales declined for the month. The NAR estimated November's "distressed" sales at 22% (12% foreclosures, 10% short sales), versus October's 24% (12% foreclosures, 12% short sales). Reflecting ongoing lending issues within the banking industry, all-cash sales in November 2012 were 30%, up from 29% in October, and up from 28% in November 2011.

The published median and average sales price data for existing homes tend to be of limited usefulness, since they usually reflect shifting patterns of home buying—between differently-priced segments—more than they do changes in truly comparative prices. That said, both median and mean existing-home sales prices in November 2012 (not seasonally-adjusted) were reported up month-to-month, and year-to-year.

WEEK AHEAD. Reflecting holiday season effects, the economic calendar is particularly light for the next week or so. Beyond what will be the short-lived effects of Hurricane Sandy, and in anticipation of the impact of the expanded QE3 and the "fiscal-cliff"/debt-ceiling negotiations on the currency markets, reporting in January and the year ahead generally should reflect higher-than-expected inflation and indicate weaker-than-expected economic results. Increasingly, previously unreported economic weakness should continue to show up in prior-period revisions.

Significant reporting-quality problems continue with most major economic series. Headline reporting issues remain 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 by the Fed's monetary policies. The political system would like to see the issues disappear, and still appears to be trying to work numerical slight-of-hand with series such as the GDP; 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, as discussed in *Hyperinflation 2012* and *No. 485: Special Commentary*).

New Home Sales (November 2012). The November new home sales report from the Census Bureau is due for release on Thursday, December 27th. As with the November housing starts and existing home sales—discussed earlier in this *Commentary*—an entrenched pattern of stagnation likely has continued in this series, with the pending reports of monthly change not likely to be statistically-significant.