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

COMMENTARY NUMBER 541
June Producer Price Index, Consumer Credit, Seasonal Adjustments

July 12, 2013

Annual June PPI Inflation Hit 15-Month High of 2.5%

0.8% Monthly PPI Jump Reflected Reversal in Negative Seasonals for Energy

Consumer Credit Growth Still Limited to Federal Student Loans

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PLEASE NOTE: The next regular Commentary *is scheduled for Monday, July 15th, covering June 2013 retail sales; followed by a* Commentary *on July 16th, covering June CPI, related series and industrial production; and a* Commentary *on July 17th covering June housing starts.*

Best wishes to all — John Williams

OPENING COMMENTS AND EXECUTIVE SUMMARY

Seasonal Factors Still Skew Headline Numbers. The seasonal-adjustment process remains broken. The system was damaged heavily in the wake of the extraordinarily severe and protracted economic contraction, which began with the 2006 downturn in the housing industry and was exacerbated by the credit and systemic-liquidity crises of 2007 and beyond. The distortions have been intensified in the context of ongoing economic turmoil, which has been driven by the structural liquidity crisis facing the consumer and reflected in a commensurate lack of economic recovery—proclaimed or pending.

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In theory, the seasonal-adjustment process allows for meaningful month-to-month comparisons of economic data. Through statistical analysis, regularly recurring patterns of business activity tied to seasonal variations (school year, change of seasons, holiday shopping, etc.) are isolated and are removed from headline monthly reporting. The adjusted results purportedly are net of these seasonal distortions, reflecting just relative changes in economic activity.

For this adjustment system to work meaningfully, however, regular patterns of seasonal activity have to persist year-after-year, for a number of years. The recent, extreme economic turmoil, however, has masked and distorted those patterns—overwhelming regular seasonal variations—with the effect of warping the resulting, adjusted data. Those unbalanced effects can be particularly extreme in month-to-month reporting, when concurrent seasonal factor adjustments are used, as seen in the headline estimates of such series as employment, unemployment, retail sales and durable goods orders (see the discussion in *Hyperinflation 2012*). Concurrent seasonal adjustments are particularly unstable in this environment. Where wildly fluctuating monthly factors are recalculated every month, heavy prior-period revisions result.

In like manner, the extreme and irregular volatility in oil prices, during this same period, have warped seasonal adjustments for the popularly followed producer price index (PPI) and consumer price index (CPI), leaving the headline month-to-month inflation numbers unusually unstable and not particularly meaningful or useful for those looking for a smoothed inflation series.

Particularly with inflation—in line with what has been the traditional and the standard approach to assessing inflation—the simplest way to avoid seasonal-factor distortions is to look at the unadjusted data on a year-to-year basis. Even on a month-to-month basis, unadjusted inflation is more meaningful than the adjusted version, at present. At least it reflects common experience in terms of prices or costs rising or falling month-to-month. With skewed seasonal adjustments, there simply is little of significance in the adjusted data, as they currently are prepared.

Latest Reporting. The week through July 12th has been particularly quiet for economic releases, except for the Bureau of Labor Statistics (BLS) release of June PPI (covered in this *Opening Comments* and *Reporting Detail* sections), and the Federal Reserve (FRB) release of May consumer credit outstanding (graphed in this *Opening Comments* section).

Expanded, monthly economic commentary, encompassing key June reporting, and an update to the *Hyperinflation Summary*, will be included in the July 16th *Commentary*.

Produce Price Index (PPI)—June 2013. In the context of the opening discussion on seasonal-adjustment issues, the headline June 2013 PPI was a monthly gain of 0.8% (0.3% before seasonal adjustments), thanks to a flip-flop in seasonal factors for energy prices. Those now-positive energy seasonals will be boosting headline inflation for the next several months.

The rounded, seasonally-adjusted 0.8% (0.3% unadjusted) monthly gain in June finished-goods PPI reflected an adjusted 2.9% (unadjusted 1.0%) month-to-month increase in finished energy prices, an adjusted 0.2% (unadjusted 0.4%) month-to-month gain in food prices, and an adjusted 0.2% (unadjusted 0.1%) month-to-month gain in "core" inflation.

At the second decimal point, June finished-goods PPI showed monthly inflation of 0.77% (up by 0.30% unadjusted), following an unrevised gain of 0.46% (up by 0.51% unadjusted) in May.

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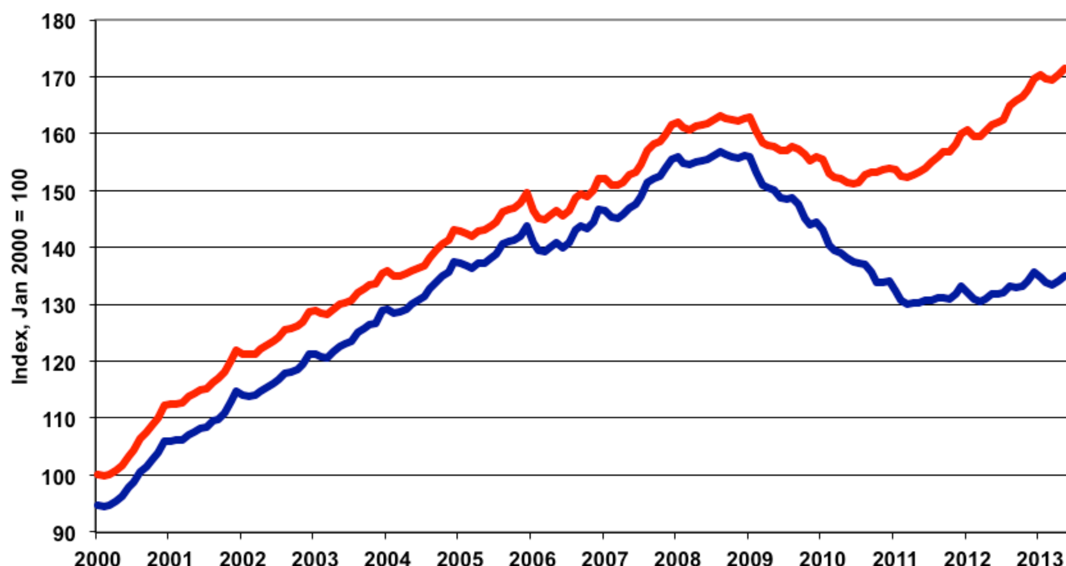
Net of the impact from warped seasonal factors, however, wholesale inflation still jumped significantly, year-to year, up by 2.49% in June 2013, versus a 1.70% annual inflation rate in May. June's annual inflation was at a 15-month high (highest since March 2012). (See *Public Comment on Inflation* for other issues on inflation reporting quality.)

Consumer Credit Outstanding—May 2013. June retail sales will be published on Monday, July 16th (see *Week Ahead*). Despite strengthening market expectations for the sales report, consumer liquidity remains structurally impaired, as has been discussed frequently (see *No. 485: Special Commentary*).

The following graph shows the estimate of May 2013 consumer credit outstanding from the Federal Reserve. As has been the case for the full post-2008 financial panic period, nearly all the growth seen in this series has been due to the expansion of federally-owned student loans.

The second graph is the latest version of real (inflation-adjusted) median household income as estimated by www.SentierResearch.com (previously published in *Commentary No. 536*). Without the income or credit to expand consumption, the consumer remains in a structural bind that will inhibit any sustainable, near-term recovery in economic activity. Those same factors have been in play for some time and mean that the U.S. consumer could not have driven or supported the purported post-2009 economic recovery. The recovery remains an illusion (again, see above-linked *No. 536*).



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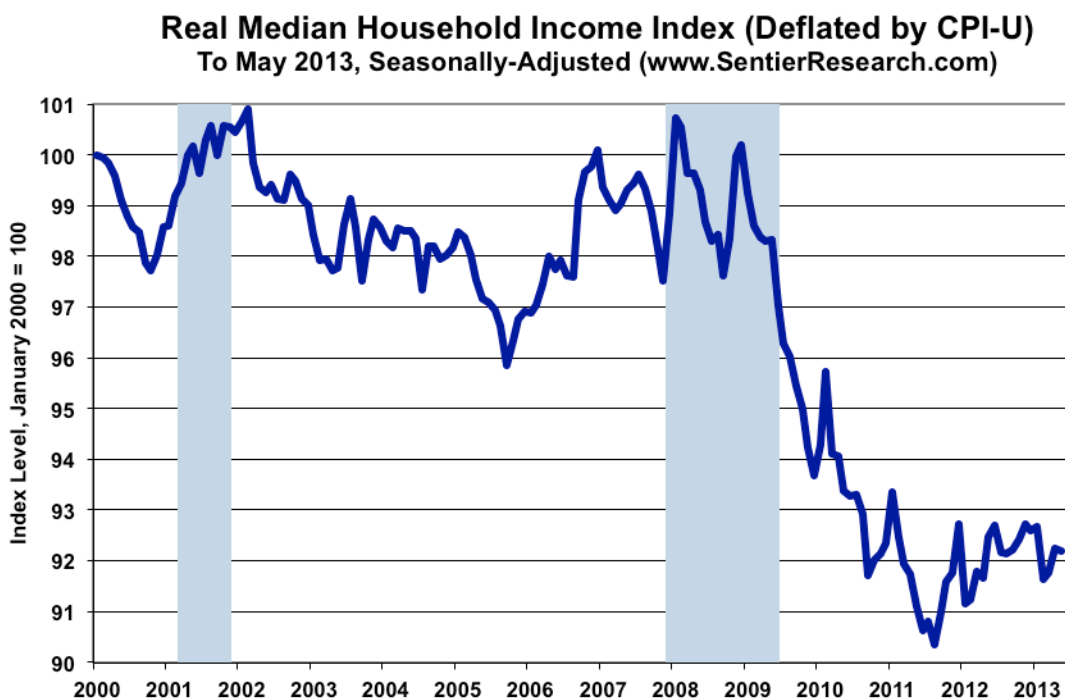

[For further detail on the June PPI, see the* Reporting Detail *section.]

HYPERINFLATION WATCH

Hyperinflation Outlook—Unchanged Summary. *[This summary will be revised in the pending CPI* Commentary *of July 16th. Otherwise, this summary has not been revised since* Commentary No. 536 *of June 26th]*. The comments here are intended as background material for new subscribers and for those looking for a brief summary of the broad outlook of the economic, systemic and inflation crises that face the United States in the year or so ahead.

Background Material. *No. 527: Special Commentary* (May 2013) supplemented *No. 485: Special Commentary* (November 2012), reviewing shifting market sentiment on a variety of issues affecting the U.S. dollar and prices of precious metals. *No. 485*, in turn, updated *Hyperinflation 2012* (January 2012)—the base document for the hyperinflation story—and the broad outlook for the economy and

inflation, as well as for systemic-stability and the U.S. dollar. Of some use, here, also is the *Public Comment on Inflation*.

These are the primary articles outlining current conditions and the background to the hyperinflation forecast, and they are suggested reading for subscribers who have not seen them and/or for those who otherwise are trying to understand the basics of the hyperinflation outlook. The fundamentals have not changed in recent years, other than events keep moving towards the circumstance of a domestic U.S. hyperinflation by the end of 2014. Nonetheless, the next, fully-updated hyperinflation report is planned for the near future.

Beginning to Approach the End Game. Nothing is normal: not the economy, not the financial system, not the financial markets and not the political system. The financial system still remains in the throes and aftershocks of the 2008 panic and near-systemic collapse, and from the ongoing responses to same by the Federal Reserve and federal government. Further panic is possible and hyperinflation remains inevitable.

Typical of an approaching, major turning point in the domestic- and global-market perceptions, bouts of extreme volatility and instability have been seen with increasing frequency in the financial markets, including equities, currencies and the monetary precious metals (gold and silver). Consensus market expectations on the economy and Federal Reserve policy also have been in increasing flux. The FOMC and Federal Reserve Chairman Ben Bernanke have put forth a plan for reducing and eventually ending quantitative easing in the form of QE3. The tapering or cessation of QE3 is contingent upon the U.S. economy performing in line with overly-optimistic economic projections provided by the Fed. Initially, market reaction pummeled stocks, bonds and gold.

Underlying economic reality remains much weaker than Fed projections. As actual economic conditions gain broader recognition, market sentiment should shift quickly towards no imminent end to QE3, and then to expansion of QE3. The markets and the Fed are stuck with underlying economic reality, and, eventually, they will have to recognize same. Business activity remains in continued and deepening trouble, and the Federal Reserve—despite currency-market platitudes to the contrary—is locked into quantitative easing by persistent problems now well beyond its control. Specifically, banking-system solvency and liquidity remain the primary concerns for the Fed, driving the quantitative easing. Economic issues are secondary concerns for the Fed; they are used as political cover for QE3. That cover will continue for as long as the Fed needs it.

At the same time, rapidly deteriorating expectations for domestic political stability reflect widening government scandals, in addition to the dominant global-financial-market concern of there being no viable prospect of those controlling the U.S. government addressing the long-range sovereign-solvency issues of the United States government. All these factors, in combination, show the end game to be nearing.

The most visible and vulnerable financial element to suffer early in this crisis likely will be the U.S. dollar in the currency markets (all dollar references here are to the U.S. dollar, unless otherwise stated). Heavy dollar selling should evolve into massive dumping of the dollar and dollar-denominated paper assets. Dollar-based commodity prices, such as oil, should soar, accelerating the pace of domestic inflation. In turn, that circumstance likely will trigger some removal of the U.S. dollar from its present global-reserve-currency status, which would further exacerbate the currency and inflation problems tied to the dollar.

This still-forming great financial tempest has cleared the horizon; its impact on the United States and those living in a dollar-based world will dominate and overtake the continuing economic and systemic-solvency crises of the last eight years. The issues that never were resolved in the 2008 panic and its aftermath are about to be exacerbated. Based on the precedents established in 2008, likely reactions from the government and the Fed would be to throw increasingly worthless money at the intensifying crises. Attempts to save the system all have inflationary implications. A domestic hyperinflationary environment should evolve from something akin to these crises before the end of next year (2014). The shifting underlying fundamentals are discussed in *No. 527: Special Commentary*; some of potential breaking crises will be expanded upon in the next revision to the hyperinflation report.

Still Living with the 2008 Crisis. There never was an actual recovery following the economic downturn that began in 2006 and collapsed into 2008 and 2009. What followed was a protracted period of business stagnation that began to turn down anew in second- and third-quarter 2012 (see new detail in *Commentary No. 530*). The official recovery seen in GDP has been a statistical illusion generated by the use of understated inflation in calculating key economic series (see *No. 527: Special Commentary*, *Commentary No. 528* and *Public Comment on Inflation*). Nonetheless, given the nature of official reporting, the renewed downturn likely will gain recognition as the second-dip in a double- or multiple-dip recession.

What continues to unfold in the systemic and economic crises is just an ongoing part of the 2008 turmoil. All the extraordinary actions and interventions bought a little time, but they did not resolve the various crises. That the crises continue can be seen in deteriorating economic activity and in the ongoing panicked actions by the Federal Reserve, where it still proactively is monetizing U.S. Treasury debt at a pace suggestive of a Treasury that is unable to borrow otherwise.

Before and since the mid-April rout in gold prices, there had and has been mounting hype about the Fed potentially pulling back on its "easing" and a coincident Wall Street push to talk-down gold prices. As discussed in *No. 527: Special Commentary*, those factors appeared to be little more than platitudes to the Fed's critics and intensified jawboning to support the U.S. dollar and to soften gold, in advance of the still-festering crises in the federal-budget and debt-ceiling negotiations. Despite orchestrated public calls for "prudence" by the Fed, and Mr. Bernanke's press conference following the June 19th FOMC meeting, the underlying and deteriorating financial-system and economic instabilities have self-trapped the Fed into an expanding-liquidity or easing role that likely will not be escaped until the ultimate demise of the U.S. dollar.

Further complicating the circumstance for the U.S. currency is the increasing tendency of major U.S. trading partners to move away from using the dollar in international trade, such as seen most recently in the developing relationship between France and China (see *No. 527: Special Commentary*).

The Fed's recent and ongoing liquidity actions themselves suggest a signal of deepening problems in the financial system. Mr. Bernanke admits that the Fed can do little to stimulate the economy, but it can create systemic liquidity and inflation. Accordingly, the Fed's continuing easing moves appear to have been primarily an effort to prop-up the banking system and also to provide back-up liquidity to the U.S. Treasury, under the political cover of a "weakening economy." Mounting signs of intensifying domestic banking-system stress are seen in softening annual growth in the broad money supply, despite a soaring pace of annual growth in the monetary base, and in global banking-system stress that followed the crisis in Cyprus and continuing, related aftershocks.

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Still Living with the U.S. Government's Fiscal Crisis. Again, as covered in *No. 527: Special Commentary*, the U.S. Treasury is in the process of going through extraordinary accounting gimmicks, at present, in order to avoid exceeding the federal-debt ceiling. Early-September appears to be the deadline for resolving the issues tied to the debt ceiling, including—in theory—significant budget-deficit cuts.

Both Houses of Congress recently put forth outlines of ten-year budget proposals that still are shy on detail. The ten-year plan by the Republican-controlled House proposes to balance the cash-based deficit as well as to address issues related to unfunded liabilities. The plan put forth by the Democrat-controlled Senate does not look to balance the cash-based deficit. Given continued political contentiousness and the use of unrealistically positive economic assumptions to help the budget projections along, little but gimmicked numbers and further smoke-and-mirrors are likely to come out of upcoming negotiations. There still appears to be no chance of a forthcoming, substantive agreement on balancing the federal deficit.

Indeed, ongoing and deepening economic woes assure that the usual budget forecasts—based on overly-optimistic economic projections—will fall far short of fiscal balance and propriety. Chances also remain nil for the government fully addressing the GAAP-based deficit that hit $6.6 trillion in 2012, let alone balancing the popularly-followed, official cash-based accounting deficit that was $1.1 trillion in 2012 (see *No. 500: Special Commentary*).

Efforts at delaying meaningful fiscal action, including briefly postponing conflict over the Treasury's debt ceiling, bought the politicians in Washington minimal time in the global financial markets, but the time has run out and patience in the global markets is near exhaustion. The continuing unwillingness and political inability of the current government to address seriously the longer-range U.S. sovereign-solvency issues, only pushes along the regular unfolding of events that eventually will trigger a domestic hyperinflation, as discussed in *Commentary No. 491*.

U.S. Dollar Remains Proximal Hyperinflation Trigger. The unfolding fiscal catastrophe, in combination with the Fed's direct monetization of Treasury debt, eventually (more likely sooner rather than later) will savage the U.S. dollar's exchange rate, boosting oil and gasoline prices, and boosting money supply growth and domestic U.S. inflation. Relative market tranquility has given way to mounting instabilities, and severe market turmoil likely looms, despite the tactics of delay by the politicians and ongoing obfuscation by the Federal Reserve.

This should become increasingly evident as the disgruntled global markets begin to move sustainably against the U.S. dollar. As discussed earlier, a dollar-selling panic is likely this year—still of reasonably high risk in the next month or so—with its effects and aftershocks setting hyperinflation into action in 2014. Gold remains the primary and long-range hedge against the upcoming debasement of the U.S. dollar, irrespective of any near-term price gyrations in the gold market.

The rise in the price of gold in recent years was fundamental. The intermittent panicked selling of gold has not been. With the underlying fundamentals of ongoing dollar-debasement in place, the upside potential for gold, in dollar terms, is limited only by its inverse relationship to the purchasing power of the U.S. dollar (eventually headed effectively to zero). Again, physical gold—held for the longer term—remains as a store of wealth, the primary hedge against the loss of U.S. dollar purchasing power.

REPORTING DETAIL

PRODUCER PRICE INDEX—PPI (June 2013)

Energy-Related Inflation Resurfaced in June as Distorting Seasonal Factors Turned Positive. As reported this morning, July 12th, by the Bureau of Labor Statistics (BLS), the regularly-volatile, seasonally-adjusted finished-goods producer price index (PPI) for June 2013 rose by a headline, month-to-month 0.8% (0.77% at the second decimal point, up by 0.30% unadjusted), following an unrevised gain of 0.5% (0.46% at the second decimal point, up by 0.51% unadjusted) in May.

June's monthly gain was dominated by higher energy prices, in the context of a turn to the positive-side of the heavily-distorted, energy-related seasonal-factor adjustments. Gains in food and core inflation were smaller, but also positive, with headline food prices depressed artificially by unstable seasonal adjustments.

The rounded, seasonally-adjusted 0.8% (0.3% unadjusted) monthly gain in June finished-goods PPI reflected an adjusted 2.9% (unadjusted 1.0%) month-to-month increase in finished energy prices, an adjusted 0.2% (unadjusted 0.4%) month-to-month gain in food prices, and an adjusted 0.2% (unadjusted 0.1%) month-to-month gain in "core" inflation.

Unadjusted and year-to-year, June 2013 total finished-goods PPI inflation rose to a 15-month high of 2.49%, from 1.70% in May. June's annual inflation was the highest since the 2.80% seen in March 2012. The June 2013 PPI, however, still remained well off its near-term July 2011 peak of 7.08%.

Core Finished Goods. "Core" inflation is net of food and energy inflation. The concept of core inflation as a realistic measure of full inflation remains 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).

That said, the core measure still is useful as an indication of how energy prices, in particular, are impacting the broad economy. For June 2013, the seasonally-adjusted, month-to-month core PPI rose by 0.16% (up by 0.30% unadjusted), versus an adjusted 0.05% gain (down by 0.05% unadjusted) in May. Year-to-year, unadjusted June 2013 core finished-goods inflation held at 1.65%, the same as in May. A comparison of core-PPI with core-CPI-U year-to-year growth in June 2013 will be graphed in the *Reporting Detail* section of the pending July 16th *Commentary* covering the June CPI.

Intermediate and Crude Goods. Reflecting generally flat to modestly higher average oil prices and mixed seasonal-factor impact, seasonally-adjusted June 2013 intermediate-goods rose by 0.5% month-to-month, following a 0.1% decline in May, while June crude-goods prices rose were flat versus May, following a 2.2% gain in May versus April.

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Year-to-year inflation in unadjusted June 2013 intermediate goods gained by 1.1%, following a 0.2% annual contraction in May. Year-to-year inflation in June 2013 crude goods jumped by 11.0%, following an annual increase of 7.6% in May.

WEEK AHEAD

Weaker Economic and Stronger Inflation Data Are Likely for June and Beyond. Despite the stronger than expected headline payroll numbers for June, the balance of upcoming June economic releases, and beyond likely will disappoint a still overly-optimistic consensus view of the broad economy. Separately, with energy-inflation related seasonal-adjustment factors swinging to the plus-side in June, combined with stable oil and higher gasoline prices for the month, higher inflation headline CPI reporting is likely in June, with higher CPI and PPI in the months ahead.

Reflecting the still-likely negative impact on the U.S. dollar in the currency markets from continuing QE3 and the still-festering fiscal crisis/debt-ceiling debacle (see *Hyperinflation Outlook* section), reporting in the ensuing months and year ahead generally should reflect much higher-than-expected inflation (see *No. 527: Special Commentary*).

While expectations for economic data in the months and year ahead should begin to soften, weaker-than-expected economic results still remain likely, given the intensifying structural liquidity constraints on the consumer. Recent downside benchmark revisions to industrial production, new orders for durable goods, retail sales, the trade deficit and construction spending suggest downside revisions to GDP growth of recent years.

Indeed, the pending, big revision event remains the July 31st comprehensive overhaul, benchmark revision and redefinition of the GDP back to 1929. A ShadowStats estimate of the likely net shift in GDP reporting patterns (generally slower growth in recent years) will be published shortly. *[Except for the detail of pending economic releases, the balance of this* Week Ahead *section is unchanged from the prior* Commentary.*]*

Reporting Quality Issues and Systemic Reporting Biases. Significant reporting-quality problems remain with most major economic series. Headline reporting issues are tied largely to systemic distortions of seasonal adjustments. The data instabilities were induced by the still-ongoing economic turmoil of the last six-to-seven years, which has been without precedent in the post-World War II era of modern economic reporting. These impaired reporting methodologies provide particularly unstable headline

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economic results, where concurrent seasonal adjustments are used (as with retail sales, durable goods orders, employment and unemployment data), and they have thrown into question the statistical-significance of the headline month-to-month reporting for many popular economic series.

With an increasing trend towards downside surprises in near-term economic reporting, recognition of an intensifying double-dip recession should continue to gain. Nascent concerns of a mounting inflation threat, though muted, increasingly have been rekindled by the Fed's monetary policies. Again, though, significant inflation shocks are looming in response to the fiscal crisis and a likely, severely-negative response in the global currency markets against the U.S. dollar.

The political system and Wall Street would like to see the issues disappear, and the popular media do their best to avoid publicizing unhappy economic news, putting out happy analyses on otherwise negative numbers. Pushing the politicians and media, the financial markets and their related spinmeisters do their best to hype anything that can be given a positive spin, to avoid recognition of serious problems for as long as possible. Those imbedded, structural problems, though, have horrendous implications for the markets and for systemic stability, as discussed in *Hyperinflation 2012*, *No. 485: Special Commentary* and *No. 527: Special Commentary*.

Retail Sales (June 2013). Scheduled for release on Monday, July 15th, by the Census Bureau, the headline June 2013 retail sales number likely will come in below developing expectations for a strong month-to-month gain. In turn, higher consumer inflation should account for the better part of any nominal (not-adjusted-for-inflation) sales gain.

Downside reporting surprises to the upside market expectations should be tied directly to the effects of continuing structural stresses on consumer liquidity, including lack of real income growth, rising taxes, and constrained credit (see *Opening Comments*). June 2013 real (inflation-adjusted) retail sales will be addressed in the Tuesday, July 16th *Commentary*, along with the detail on the June 2013 CPI-U.

Consumer Price Index—CPI (June 2013). The release by the Bureau of Labor Statistics (BLS) of the June 2013 CPI numbers is scheduled for Tuesday, July 16th. The headline CPI is a fair bet to come in near or above a developing, positive, market consensus.

Average gasoline prices rose month-to-month in June 2013 by 0.4 percentage point, on a not-seasonally-adjusted basis, per the Department of Energy. The BLS seasonal adjustments, however, should boost that monthly gain significantly. As recently revised, an unadjusted monthly 6.1% decline in June 2012 gasoline prices was narrowed to a 0.6% decline by upside seasonal adjustments. Similar effects in the June 2013 number would restore some of the energy-related inflation that was not otherwise counted in the first-half 2013. Given likely upside inflation pressures from food prices and core inflation, a modest headline gain in June 2013 CPI-U is a reasonable expectation. By itself, gasoline inflation should add roughly 0.3 percentage point to the monthly headline June 2013 CPI-U.

Year-to-year, CPI-U inflation would increase or decrease in June 2013 reporting, dependent on the seasonally-adjusted monthly change, versus a reported 0.12% gain in monthly inflation for June 2012. The adjusted change is used here, since that is how consensus expectations are expressed. To

approximate the annual unadjusted inflation rate for June 2013, the difference in June's headline monthly change (or forecast of same), versus the year-ago monthly change, should be added to or subtracted directly from the May 2013 annual inflation rate of 1.36%. For example, a headline 0.3% June CPI-U gain would boost the June annual CPI-U inflation to around 1.5% or 1.6%.

Index of Industrial Production (June 2013). The June 2013 index of industrial production also is scheduled for release on Tuesday, July 16th, by the Federal Reserve Board (FRB). With inventories still too high for existing demand, an outright monthly contraction in production is possible. Reporting below developing positive expectations is a fair shot for June, even with some likelihood that unseasonably hot weather will have spiked monthly utility usage to the extent of offsetting some of the weakening production in the manufacturing sector.

Residential Construction (June 2013). On Wednesday, July 17th, the Census Bureau will publish its estimate of June 2013 housing starts activity. Despite developing market expectations for a strong headline gain, reported month-to-month change likely will continue to be statistically-insignificant, with ongoing stagnation in activity, particularly for single-unit housing starts.

In the wake of a 75% collapse in aggregate activity from 2006 through 2008, and an ensuing four-year pattern of housing starts stagnation at historically low levels, little has changed. There remains no chance of a near-term, sustainable turnaround in the housing construction market, unless there is a fundamental upturn in consumer and banking liquidity conditions. That has not happened and does not appear to be in the offing.

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