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

COMMENTARY NUMBER 609
February Industrial Production, PPI

March 17, 2014

February Production Effectively Was Stagnant,
Net of Continued Unseasonable Weather Effects

For Third Month, Strong PPI Goods Inflation Was Offset by Weak Services Inflation

Last Three Months of PPI Inflation Annualized to 5.1% for Goods (Traditional Series)
Versus 0.7% for "Final Demand" Goods and Services (New Series)

PLEASE NOTE: The next regular Commentary *is scheduled for tomorrow, Tuesday, March 18th, covering the February CPI and related real retail sales and earnings, plus February housing starts. The expanded* Special Commentary *on 2013 U.S. GAAP accounting and the* Second Installment *on the hyperinflation report will be published soon. Specific timing will be posted in the schedule box on the home page of www.ShadowStats.com.*

Best wishes to all — John Williams

OPENING COMMENTS AND EXECUTIVE SUMMARY

Production Numbers Roiled by Unstable Weather Patterns. Today's (March 17th) reporting of February industrial production showed a stronger than expected 0.6% headline gain, but that remained in the realm of unstable reporting due to continuing distortions from the unseasonable weather. In January

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production, part of the revised 0.9% headline decline in manufacturing was due to negative effects of unseasonably bad weather, but that largely was offset in the aggregate by a 3.8% headline jump in utility usage, spiked by the same problems. As a result, the total production reading for January was reasonably balanced at a revised 0.2% decline.

In February, with unseasonably cold weather remaining, utility usage stayed at about the same level as January's elevated reading (down by 0.2%), but with less snowstorm disruption for people going to work, manufacturing regained (up by 0.8%) its pre-January reading. Had utility usage reversed its big gain from the month before, the aggregate headline production number would have been little changed in February from January, but that catch-up awaits future reporting.

On the inflation front, the new PPI series continued to show strong goods inflation in February, offset by weakness in the service sector. The new headline wholesale-inflation reporting is far shy of generating meaningful aggregate inflation numbers.

Today's relatively brief *Commentary* concentrates on the February production and PPI reporting. Tomorrow's March 18th *Commentary No. 610*, covering February CPI and housing starts will provide a general review of the latest economic reporting. That will be followed shortly by *Hyperinflation 2014—Renewed Economic Tumble* (the second installment to the hyperinflation report), which will provide an extensive review of economic activity, along with what likely will unfold in the months and year ahead.

Industrial Production—February 2014—Ongoing Weather Distortions Turned Monthly Stagnation into a Headline Gain. As just discussed, proper accounting for unseasonable weather conditions would have left headline aggregate February production growth stagnant, much as was seen in January's aggregate reporting.

Accordingly, the latest production numbers, which face a major benchmark revision and subsequent March reporting in the month ahead, likely remain well within the scope of a contracting first-quarter 2014 GDP.

Massive Benchmark Revisions Loom. In eleven days, on Friday, March 28th, the Federal Reserve will publish its benchmark revisions to industrial production, incorporating new information, revised methodologies and seasonal factors back to January 1972. Accordingly, the following details on the headline February data effectively are already outdated.

Industrial Production—February 2014. Headline February industrial production rose by 0.62% for the month, and was up by 0.60%, net of prior-period revisions. January showed a revised 0.18% decline, versus a revised 0.04% decline (previously a 0.32% gain) in December, and versus an upwardly revised 0.94% gain in November.

Year-to-year growth in February 2014 production slowed to 2.83%, from a revised 2.88% in January, a downwardly-revised 3.09% in December 2013, and an upwardly revised 3.17% in November. Allowing for series volatility and special factors tied to weather-related utility distortions, annual growth still has slowed to levels usually seen at the onset of recessions and at levels seen leading into the 2008 economic collapse. Graphs of production level and year-to-year growth are shown in the *Reporting Detail* section.

Production Series at Historic High, Still Inconsistent With the GDP. The headline production series had moved above its pre-recession high, for the first time, in November 2013. With the headline February 2014 production index level at 101.63 (Index = 100 in 2007), it remains marginally higher than the December 2007 pre-recession peak of 100.82, but that gain is not of statistical significance.

The "recovery" is not real. The use of understated inflation in deflating certain components compiled in the production index has resulted in overstated headline production growth. As shown in the following "corrected" graph, production remains well shy of an economic recovery.

Additionally, industrial production widely is recognized as a coincident indicator of GDP activity. It is used, for example, by the recession-defining authority—the National Bureau of Economic Research (NBER)—for timing the onsets of recessions. What is unusual here is that the headline GDP purportedly has been fully recovered (again a function of deflation by understated inflation), in economic expansion, since second-quarter 2011. If the GDP data and the production numbers were of consistent good quality, the two series would be moving together, rather than the production numbers lagging GDP reporting by eleven quarters. As discussed frequently, and as covered in *Commentary No. 585* and here, there are serious reporting flaws with both series, particularly the GDP.

Corrected Industrial Production. Hedonic quality adjustments to inflation, understate the inflation used in calculating some components of industrial production. That has the effect of overstating the resulting inflation-adjusted growth in the headline industrial production series (see *Special Commentary: No. 485*, *Public Comment on Inflation* and discussion in the forthcoming *Second Installment* to the hyperinflation report).

The two accompanying graphs address that issue. The first reflects official industrial production reporting, indexed to January 2000 = 100, instead of the Fed's formal index that is set at 2007 = 100. The 2000 indexing is used simply to provide for some consistency in this series of revamped graphics; it does not affect the appearance of the graph or reported growth rates. The second graph is a version of the first that has been corrected for the understatement of the inflation rate used in deflating the production index, with estimated hedonic-inflation adjustments backed-out of the official industrial-production deflator.

The "corrected" graph does show some growth in the period following the official June 2009 near-term trough in production activity. Yet, that upturn has been far shy of the full recovery and the renewed expansion reported in official GDP estimation; corrected production levels have not recovered pre-recession highs. Instead, corrected production entered a period of protracted low-level stagnation in 2012, with quarterly contractions in third-quarter 2012, second-quarter 2013, with stagnation in third-quarter 2013, and minimal upturn in the fourth-quarter 2013 (second graph).

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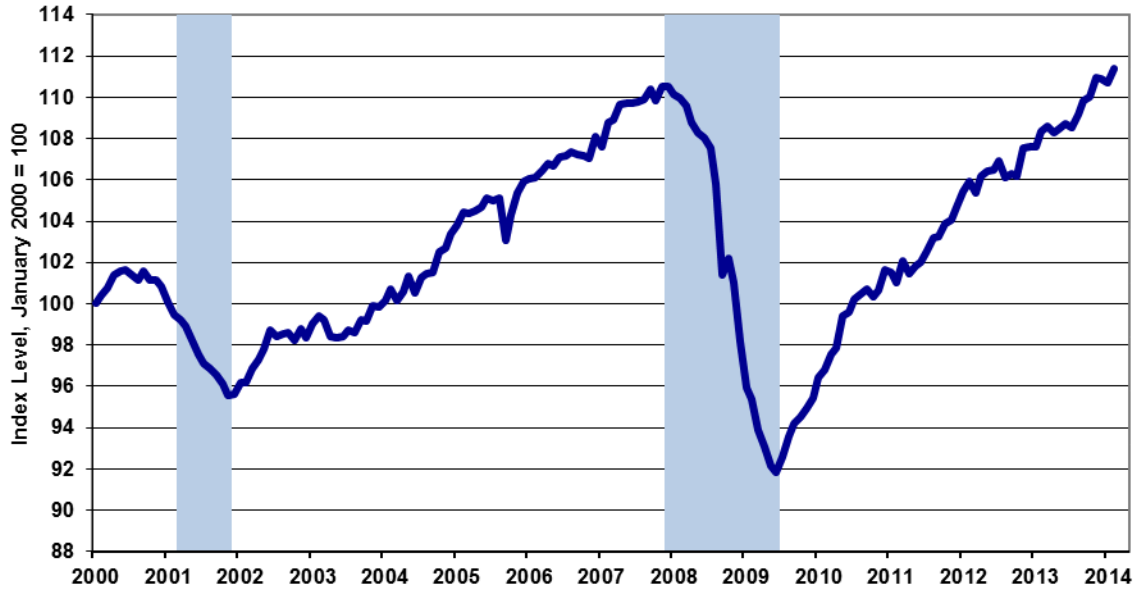

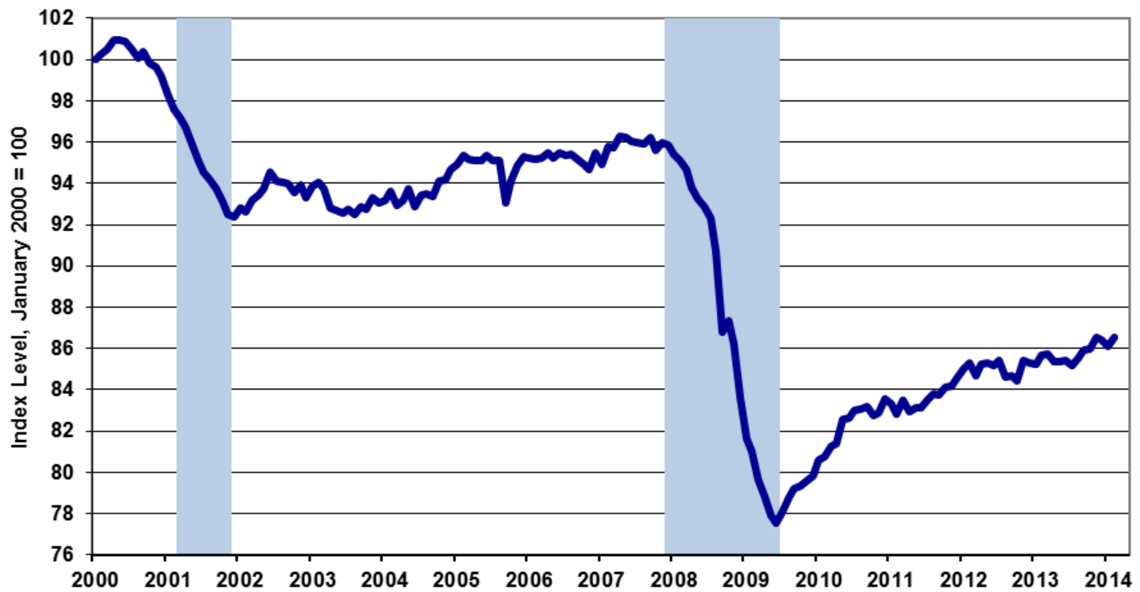

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PPI—February 2014—Goods Inflation Contained Again by a Suffering Services Sector. For the third straight month, the new PPI showed a jump in goods inflation, which was muted sharply by lower services inflation. As discussed in *Commentary No. 591*, a new producer price index (PPI)—effective with January 2014 reporting—replaced the headline monthly measure of wholesale inflation in "finished goods," with a headline monthly measure of wholesale "total final demand," which is composed of "final demand goods" (basically the old "finished goods" series) and "final demand services." The latter category tends to cap the goods inflation when oil prices are an issue, and otherwise it is perhaps counter-indicator to inflation.

Weak Inflation in New PPI Series Could Be Signal for Stronger General Inflation Ahead. As opposed to "final demand goods," which measures the costs of material and production, "final demand services" largely reflects highly questionable surveying of intermediate or quasi-wholesale profit margins in the services area. To the extent that profit margins shrink in the services sector, one could argue that the resulting lowered estimation of inflation actually is a precursor to higher inflation, as firms move to raise prices in an effort to regain more-normal margins. The new PPI series is an interesting concept, but likely limited as to its aggregate predictive ability versus general consumer inflation. There is not enough history available on the new series (just five years of post-2008-panic data) to establish any meaningful predictive relationship of the services-sector to general inflation, while the goods-sector relationship has been established for many years.

In the second month of the new reporting (third month counting the *pro forma* estimate published for December "new" reporting), the pattern of services containing inflation from higher energy and food prices was seen again in the headline February 2014 detail. Headline "final demand goods" rose by 0.4% in February 2014, the same as in January, and the same as estimated for the new series in December 2013.

That also was the same pace of inflation shown for the last official headline reporting of the old "final demand" series in December 2013. Due, however, to the headline "final demand services" monthly contraction of 0.3% in February, inflation of 0.1% in January, and a 0.1% contraction in December, the headline monthly aggregate inflation in the new "total final demand" was a contraction of 0.1% in February 2014, a 0.2% gain in January, and a 0.1% gain in December 2013. As a result, PPI inflation in the last three months annualized to 5.1% for goods (effectively the traditional series), versus 0.7% for "total final demand" in goods and services (the new series).

Also with the new series, prior categories of "crude" and "intermediate" goods inflation have been recast into processed and unprocessed goods and services for intermediate demand. Intermediate demand also is broken into four stages of production flow for both goods and services. The new data here often appear to be of limited meaning on the services side, little more than a dog's breakfast of theoretical constructs. As previously discussed, ShadowStats coverage in these areas will tend to be defined by subscriber needs and interests. Please let us know of any special interests you have here.

February 2014 Headline PPI Detail. The headline PPI for February 2014 reflected a 0.09% month-to-month decline in "total final demand" inflation, following a 0.18% gain in January. Year-to-year, February inflation slowed to 0.9% from a 1.20% annual gain in January.

Broken out in the two major subcomponents for the new series, the "final demand goods" sector showed headline monthly inflation of 0.35% in February 2014, versus 0.44% in January, with year-to-year

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inflation of 0.62% in February 2014, versus 0.89% in January. The "final demand services" sector showed headline monthly inflation contracting by 0.28% in February 2014, versus a 0.09% monthly gain in January, with year-to-year inflation of 1.03% in February 2014 versus 1.32% in January.

[For greater detail on February industrial production and PPI, see the* Reporting Detail *section.]

HYPERINFLATION WATCH

Hyperinflation Outlook. With the *First Installment* of *Hyperinflation 2014—The End Game Begins* published, a new *Hyperinflation Summary* for this section will be added in conjunction with the publication of the *Second Installment*, which remains planned for the immediate future. Specific timing will be posted in the schedule box on the home page of www.ShadowStats.com.

The second and final installment will cover historical and prospective economic activity, as well as possible protective and preventative actions and reactions at both a personal and federal level, versus the unfolding circumstance. It also will include analysis of the 2013 GAAP-based financial statements of the United States government (released February 27th) and detail from the Federal Reserve's 2013 annual flow-of-funds analysis (released on March 6th). The new material in the *Second Installment* will supplement and update the basic material already available to ShadowStats readers in Chapters 4, 5 and 9 of *Hyperinflation 2012*.

REPORTING DETAIL

INDEX OF INDUSTRIAL PRODUCTION (February 2014)

Although Utility Usage Was Down by 0.2%, Weather Impact Resulted in Overstated Headline Production Growth. February industrial production showed a stronger-than-expected 0.6% headline

gain, but that remained in the realm of unstable reporting due to continuing distortions from the unseasonable weather. In January, part of the revised 0.9% headline decline in manufacturing was due to negative effects of unseasonably bad weather, but that largely was offset in the aggregate by a 3.8% headline jump in utility usage, spiked by the same problems. As a result, the production reading for January was reasonably balanced at a revised 0.2% decline.

In February, with unseasonably cold weather remaining, utility usage stayed at about the same level as January's elevated reading (down by 0.2%), but with less snowstorm disruption for people trying to go to work, manufacturing regained (up by 0.8%) its pre-January reading. Had utility usage reversed its big gain from the month before, the aggregate headline production number would have been little changed in February from January, but that catch-up awaits future reporting.

Production Series at Historic High, Still Inconsistent With the GDP. The headline production series had moved above its pre-recession high, for the first time, in November 2013. With the headline February 2014 production index level at 101.63 (Index = 100 in 2007), it remains marginally higher than the December 2007 pre-recession peak of 100.82, but that gain is not of statistical significance.

This "recovery" is not real, as discussed in *Corrected Industrial Production* in the *Opening Comments* section. The use of understated inflation in deflating certain components compiled in the production index has resulted in overstated headline production growth. As shown in the "corrected" graph there, production remains well shy of an economic recovery.

Additionally, industrial production widely is recognized as a coincident indicator of GDP activity. It is used, for example, by the recession-defining authority—the National Bureau of Economic Research (NBER)—for timing the onsets of recessions. What is unusual here is that the headline GDP purportedly has been fully recovered, in economic expansion, since second-quarter 2011. If the GDP data and the production numbers were of consistent good quality, the two series would be moving together, rather than the production numbers lagging GDP reporting by eleven quarters. As discussed frequently, and as covered in *Commentary No. 585* and here, there are serious reporting flaws with both series, particularly the GDP (also with understated-inflation issues).

Massive Benchmark Revisions Loom. On Friday, March 28th, the Federal Reserve will publish its benchmark revisions to industrial production, incorporating new information, revised methodologies and seasonal factors, back to January 1972. Accordingly the following headline data effectively are already outdated.

Industrial Production—February 2014. The Federal Reserve Board released its estimate of seasonally-adjusted, February 2014 industrial production this morning, March 17th. In the context of relative upside and downside offsetting revisions to November and December 2013 production activity (January effectively was unrevised in level), headline monthly February production rose by 0.6% (0.62% at the second decimal point) and was up by 0.60% for the month, net of prior-period revisions. January showed a revised 0.18% (previously 0.33%) decline, versus a revised 0.04% decline (previously a 0.32%, initially a 0.31% gain) in December, and versus a revised 0.94% (previously a 0.66%, a 1.04% and initially a 1.13%) gain in November.

Year-to-year growth in February 2014 production slowed to 2.83% from a revised 2.88% (previously 2.91%) in January, a downwardly-revised 3.09% (previously 3.27%, initially 3.68%) in December 2013,

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and an upwardly revised 3.17% (previously 2.98%, 3.40% and initially 3.23%) in November. Allowing for series volatility and special factors tied to weather-related utility spikes, annual growth still has slowed to levels usually seen at the onset of recessions and at levels seen leading into the 2008 economic collapse.

Production Graphs. The "recovery" in industrial production is reflected in the following two sets of graphs. The first graph in the first set shows the monthly level of the production index, while the second graph shows the year-to-year or annual percentage change in the same series for recent historical detail, beginning January 2000.

The second set of graphs shows the same data in historical context since World War II.

As shown more clearly in the first set of graphs, current year-to-year activity recently dipped lower, with annual growth close to levels last seen in a slowing-growth pattern in the first two quarters of the formal 2007 recession. The higher annual growth rates, initially seen in the last half of 2013, have fallen back in revision and should revert back to the earlier patterns as excess inventories are worked off. Annual growth remains well off the recent relative peak for the series, which was 8.50% in June 2010, going against the official June 2009 trough of the economic collapse. Indeed, as shown in the second set of graphs, the year-to-year contraction of 15.02% in June 2009, at the end of second-quarter 2009, was the steepest annual decline in production since the shutdown of war-time production following World War II.

Official production levels have moved higher since the June 2009 trough, and the headline series is at an all-time high, above peak pre-recession activity, as of February 2014 reporting. Corrected for the understatement of inflation used in deflating portions of the industrial production index, however, the series has shown more of a pattern of stagnation with a slow upside trend, since 2009, topping out into 2012, with a renewed slight upturn into a recent, protracted period of inventory build-up, and now downturn with inventory liquidation. The corrected production series is discussed and graphed in the *Opening Comments*.

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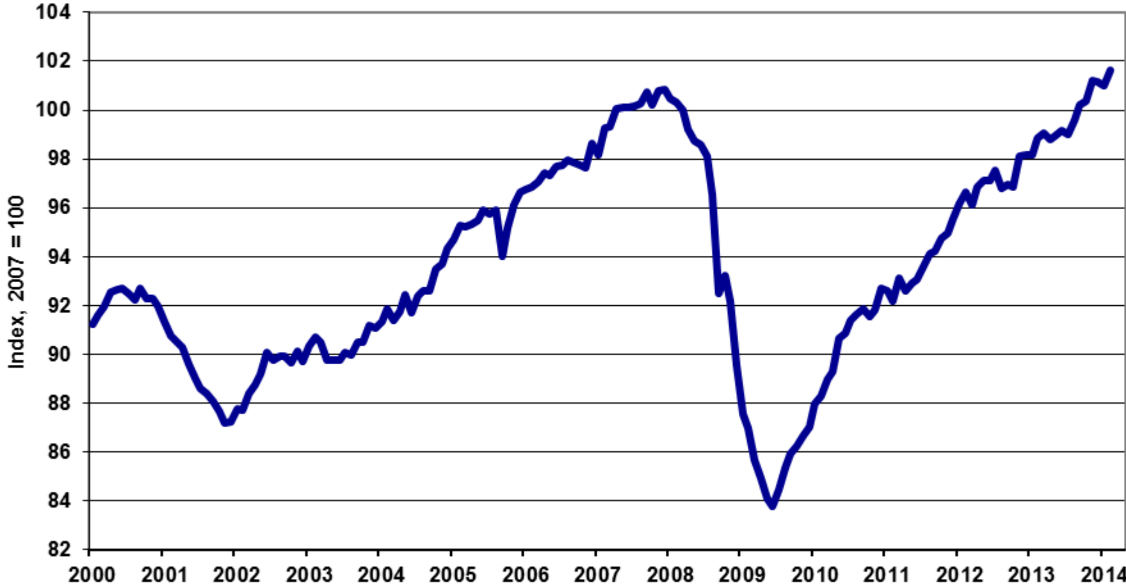

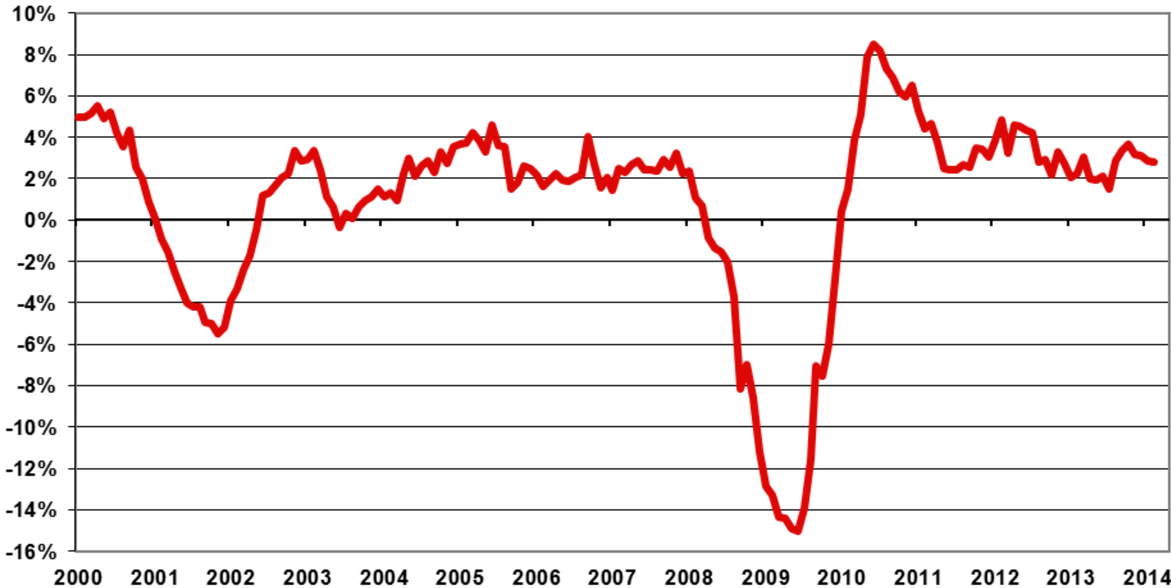

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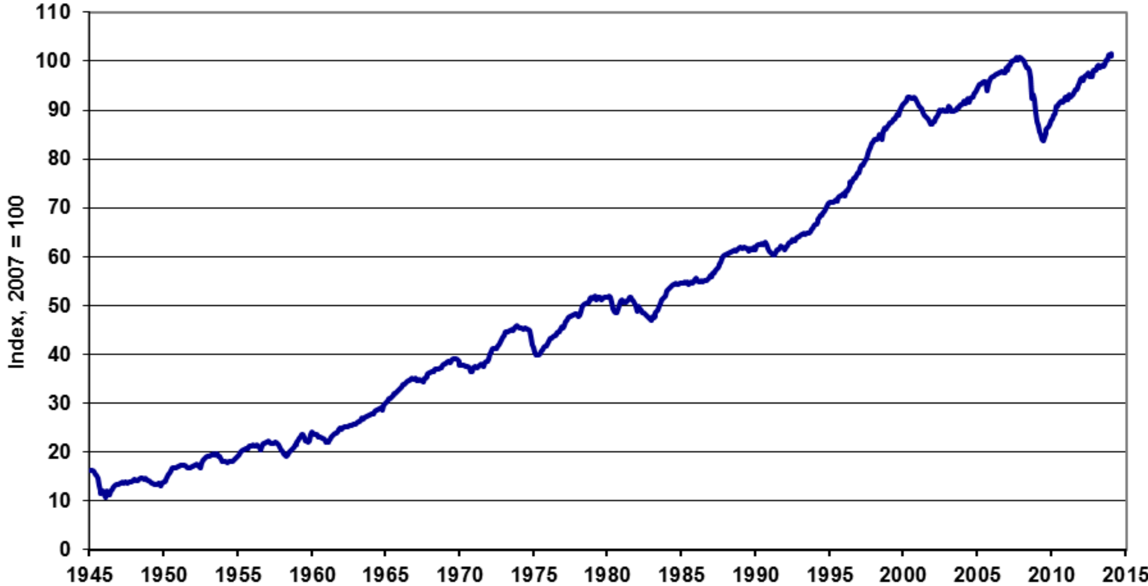

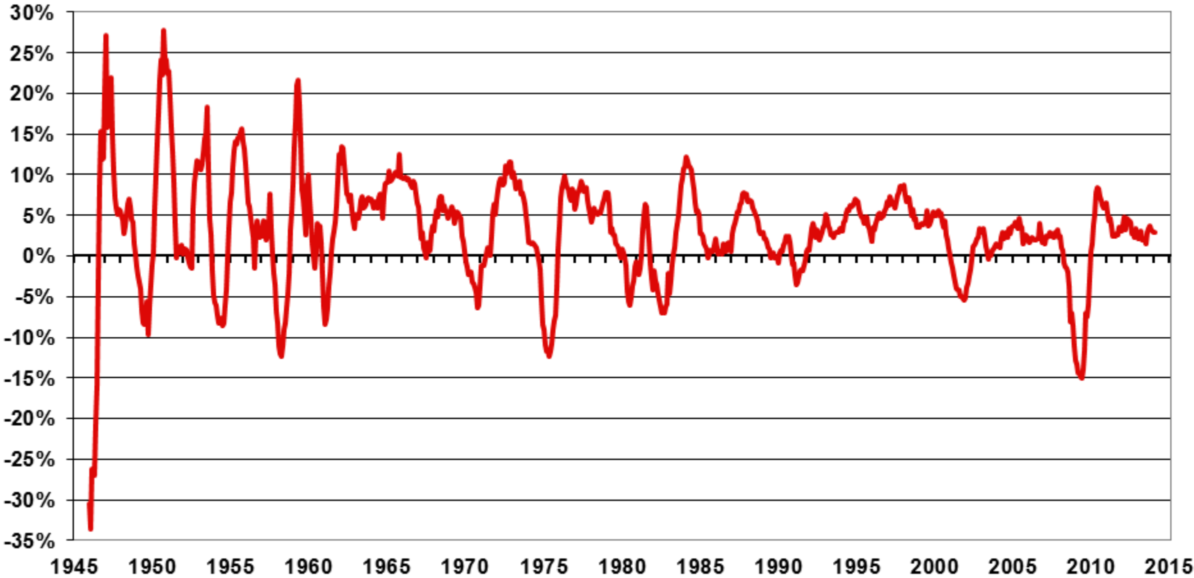

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PRODUCER PRICE INDEX—PPI (February 2014)

For the Third Straight Month, New PPI Showed an Inflation Jump in Goods, Sharply Muted by Lower Inflation in Services. As discussed in *Commentary No. 591*, a new producer price index (PPI)—effective with January 2014 reporting—replaced the headline monthly measure of wholesale inflation in "finished goods," with a headline monthly measure of wholesale "total final demand," which is composed of "final demand goods" (basically the old "finished goods" series) and "final demand services" which tends to cap the goods inflation when oil prices are an issue.

Weak Inflation in New PPI Series Could Be Signal for Stronger General Inflation Ahead. As opposed to "final demand goods," which measures the costs of material and production, "final demand services" largely reflects highly questionable surveying of intermediate or quasi-wholesale profit margins in the services area. To the extent that profit margins shrink in the services sector, one could argue that the resulting lowered estimation of inflation actually is a precursor to higher inflation, as firms move to raise prices in an effort to regain more-normal margins. The new PPI series is an interesting concept, but likely limited as to its aggregate predictive ability versus general consumer inflation. There is not enough history available on the new series (just five years of post-2008-panic data) to establish any meaningful predictive relationship to general inflation, while the goods sector relationship has been established for many years.

In the second month of the new reporting (third month counting the *pro forma* estimate published for December "new" reporting), the pattern of services containing inflation from higher energy and food prices was seen again in the headline February 2014 detail. Headline "final demand goods" rose by 0.4% in February 2014, the same as in January, and the same as estimated for the new series in December 2013. That also was the same pace of inflation shown for the last official headline reporting of the old "final demand" series in December 2013. Due, however, to the headline "final demand services" monthly contraction of 0.3% in February, inflation of 0.1% in January, and a 0.1% contraction in December, the headline monthly aggregate inflation in the new "total final demand" was a contraction of 0.1% in February 2014, a 0.2% gain in January, and a 0.1% gain in December 2013.

With the new series, prior categories of "crude" and "intermediate" goods inflation have been recast into processed and unprocessed goods and services for intermediate demand. Intermediate demand also is broken into four stages of production flow for both goods and services. The new data here often appear to be of limited meaning on the services side, little more than a dog's breakfast of theoretical constructs. As previously discussed, ShadowStats coverage in these areas will tend to be defined by subscriber needs and interests.

February 2014 Headline PPI Detail. The Bureau of Labor Statistics (BLS) reported on March 14th, that the headline producer price index (PPI) for February 2014 reflected a 0.09% month-to-month decline in "total final demand" inflation, following 0.18% gain in January. Year-to-year, February inflation slowed to 0.9% from a 1.20% annual gain in January.

Broken out in the two major subcomponents for the new series, the "final demand goods" sector showed headline monthly inflation of 0.35% in February 2014, versus 0.44% in January, with year-to-year inflation of 0.62% in February 2014, versus 0.89% in January. The "final demand services" sector

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showed headline monthly inflation contracting by 0.28% in February 2014, versus a 0.09% monthly gain in January, with year-to-year inflation of 1.03% in February 2014 versus 1.32% in January.

Descriptive materials on the new, revamped PPI series remain available on the BLS Web site here: *New PPI Series*, *New PPI Detail*, and today's *Press Release*.

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WEEK AHEAD

Much Weaker-Economic and Stronger-Inflation Reporting Likely in the Months and Year Ahead. Although shifting to the downside, market expectations generally still appear to be overly optimistic as to the economic outlook. Expectations should continue to be hammered, though, by continuing, downside corrective revisions and continued, disappointing headline economic activity. The initial stages of that process have been seen in the recent headline reporting of most major economic series.

That corrective circumstance and underlying weak economic fundamentals remain highly suggestive of deteriorating business activity. Accordingly, weaker-than-consensus economic reporting should become the general trend until such time as the unfolding "new" recession receives general recognition.

Stronger inflation reporting remains likely. Upside pressure on oil-related prices should reflect intensifying impact from a weakening U.S. dollar in the currency markets, and from ongoing global political instabilities. The dollar faces pummeling from continuing QE3, the ongoing U.S. fiscal-crisis debacle, a weakening U.S. economy and deteriorating U.S. and global political conditions (see *Hyperinflation 2014—The End Game Begins*). Particularly in tandem with a weakened dollar, reporting in the year ahead generally should reflect much higher-than-expected inflation.

A Note on Reporting-Quality Issues and Systemic Reporting Biases. Significant reporting-quality problems remain with most major economic series. Ongoing headline reporting issues are tied largely to systemic distortions of seasonal adjustments. The data instabilities were induced by the still-evolving economic turmoil of the last eight 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 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.

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PENDING RELEASES:

Consumer Price Index—CPI (February 2014). The release by the Bureau of Labor Statistics (BLS) of the February 2014 CPI is scheduled for tomorrow, Tuesday, March 18th. The headline CPI-U is a fair bet to be close to unchanged for the month, perhaps minimally on the plus-side

Average gasoline prices rose month-to-month in February 2014 by 1.2%, on a not-seasonally-adjusted basis, per the Department of Energy, but BLS seasonal adjustments will depress gasoline prices in the headline February CPI. As last revised, an unadjusted 10.1% monthly gain in February 2013 gasoline prices was reduced to a 7.0% monthly gain, with negative seasonal adjustments. Similar effects in the February 2014 number, by themselves, would subtract about 0.1% from the headline CPI-U number. Upside food prices and core inflation, however, should more than offset that decline, slightly, leaving the headline CPI-U on the plus-side of unchanged for the month.

Year-to-year, CPI-U inflation would increase or decrease in February 2014 reporting, dependent on the seasonally-adjusted monthly change, versus an adjusted 0.35% increase in the monthly inflation reported for February 2013. The adjusted change is used here, since that is how consensus expectations are expressed. To approximate the annual unadjusted inflation rate for February 2014, the difference in February's headline monthly change (or forecast of same), versus the year-ago monthly change, should be added to or subtracted directly from the January 2014 annual inflation rate of 1.58%. For example, if headline February 2014 CPI-U gained 0.1%, the annual inflation rate likely would be about 1.3% or 1.4%.

Residential Construction—Housing Starts (February 2014). Also scheduled for tomorrow, Tuesday, March 18th, the Census Bureau will publish its estimate of February 2014 housing starts.

This series was distorted heavily to the upside by data-gathering and reporting issues that resulted from the government shutdown in October, and it is still suffering reporting instabilities. Despite near-perpetual market expectations for strengthening activity in housing starts, month-to-month change likely will remain in a pattern of statistical-insignificance, with ongoing stagnation and renewed downturn seen in the aggregate series, as well as particularly in single-unit housing starts.

In the wake of a 75% collapse in aggregate activity from 2006 through 2008, and an ensuing five-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 still does not appear to be in the offing.

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